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## **Assessing the Consequences of the Economic Partnership Agreement on the Ethiopian Economy**

Hakim Ben Hammouda and Stephen Karingi and Ben Idrissa  
Ouedraogo and Nassim Oulmane and Mustapha Sadni Jallab

United Nations Economic Commission for Africa

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# ATPC

Work in Progress

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Economic Commission for Africa

## African Trade Policy Centre

# Assessing the Consequences of the Economic Partnership Agreement on the Ethiopian Economy

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## Abstract

The results presented indicate that a free trade area would reinforce the linkages between Ethiopia and European countries, including traditional partners such as Italy, with implications for the regional integration arrangements that Ethiopia is currently involved in. There will be significant trade diversion away from other African countries currently trading with Ethiopia. The diversion will occur in the low-technology sectors, which are potentially good foundations for deepened regional integration based on trade in industrial goods. The results further indicate some important implications with respect to Ethiopia's industrialization strategy. The liberalization of industrial sectors result in more trade effects, particularly negative trade diversion, compared to the results from agricultural liberalization. The loss in revenue, which is a strong feature in general liberalization, is at the sectoral level, more pronounced in the industrial liberalization. The economic structure of Ethiopia, which supports self-reliance in food from the agriculture sector, underpins the limited losses in agriculture as compared to the industrial sector. Clearly, instead of opening the doors to economic diversification, the EPA could lead Ethiopia to deepen its comparative advantages in agricultural products.

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# Table of Contents

<b>I. Introduction .....</b>	<b>1</b>
<b>II. Economic and Trade environment in Ethiopia.....</b>	<b>4</b>
2.1 Economic environment.....	4
2.2 Evolution of trade policies.....	5
2.3 Ethiopia's trade performance .....	7
<b>III. Trade simulations on the Economic Partnership Agreements reform.....</b>	<b>8</b>
3.1 Full liberalization of all the imports from the EU to Ethiopia.....	9
3.2 Sectoral approach (i) Agricultural Scenario.....	17
3.3 Sectoral approach (2) Industrial Scenario .....	20
3.4 Full liberalization with EU and COMESA.....	24
3.5 Sensitive products .....	32
<b>IV. Adjustment costs.....</b>	<b>39</b>
<b>V. Conclusion.....</b>	<b>41</b>
<b>References .....</b>	<b>43</b>





## Introduction

Ethiopia is currently engaged in trade negotiations with the European Union (EU) through the framework of the African Caribbean and Pacific (ACP) countries – (EU) relations. These negotiations may lead to an Economic Partnership Agreement (EPA) with the EU by January 2008, which will be the new cooperative framework based on partnership, cooperation, trade and political dialogue between the EU and the ACP countries. After the implementation of the free-trade agreement, which may last more than ten years after 2008, ACP countries will have to reciprocate on their tariffs on exports from the EU, as a counterpart of the duty free access their exports will enjoy in European markets. From 1975 to 2000, the ACP-EU relations were governed by the Lomé Conventions. During this period, ACP countries were benefiting from non-reciprocal preferential trade agreements from the EU. In the mid 1990s, the EU initiated a revision of their cooperation with the ACP countries in order to adapt the framework of these relations to the new global context: globalization, poverty reduction and sustainable development.

Regarding trade cooperation, there was a need to render the ACP-EU arrangements compatible with the World Trade Organization's (WTO) rules. Indeed, the ACP-EU non-reciprocal preferential trade arrangement departs from the Most Favored Nation clause of the WTO that forbids discrimination. Ideally, the EU would be expected to advance similar preferences to non-ACP countries with the same level of development as the ones being enjoyed by ACP countries<sup>1</sup>. It should be noted that the EU could still unilaterally establish a non-reciprocal preference system that favors all the developing countries and remain WTO compliant. For instance, the Everything-But-Arms (EBA) initiative is one such arrangement granted under the enabling clause of the WTO that allows developed countries to provide a favorable non-reciprocal preference system to developing countries. In this case, the EU is granting duty free access to all imports originating from Least Developed Countries (LDCs) globally, including Ethiopia. Therefore, in order to maintain such specific cooperation between ACP countries and the EU, the trade arrangement should take the format of a Free Trade Agreement (FTA) and abide to the article XXIV of the General Agreement on Tariffs and Trade (GATT) in order to be WTO compatible. This article requires that any FTA formed should liberalize "substantially all trade" (which has been interpreted to mean at least 90% of the intra-FTA member countries trade) and this has to be done within a reasonable period of time (interpreted to be 10 years or so). As a result of the review process, the Cotonou Partnership Agreement (CPA) was signed in June 2000. This CPA defines the new cooperation framework between the ACP countries and the EU to be in place for 20 years. The key principles of the CPA are reciprocity, differentiation, deeper regional integration, and coordination of trade and aid. The CPA has adopted the Economic Partnership Agreement (EPA) as the new framework for economic and trade cooperation between the two groups of partners. The EPAs are far more than a trade agreement designed for ACP countries. The primary aim of this cooperation is to contribute to the development of a trade regime that promotes sustainable development and the integration of ACP countries into the world economy.

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1. Ethiopia is negotiating its accession to the WTO.

Basically, the EPAs should serve as development instruments in facilitating smooth integration of the ACP countries in the world economy while respecting their political options and development objectives. EPAs should support and promote the existing regional integration initiatives and not compromise them. EPAs should maintain and improve the current level of preferential access of ACP exports to the EU market. EPAs should confer a special and differential treatment to the most vulnerable ACP countries. EPAs need to be WTO compliant.

Yet, the EPAs need to be negotiated during an interim period starting from 2000 and ending in December 2007 according to the following schedule:

- Phase I of the negotiations was ACP-wide and began in September 2002.
- Phase II, which began in October 2003, is based on regional negotiations and will continue until 2008.

During phase I, the CPA presupposed that ACP member countries will self-determine an appropriate configuration within which they will negotiate the EPAs. The EU displayed its preference for a Regional Economic Community (REC) under which to negotiate the new EPA. The REC could either be a Free Trade Area or a Customs Union. The EU's preference for the RECs is related to its wishes to deepen regional integration processes among ACP countries. This would happen especially if trade among the African countries in the FTA or the CU increased. Indeed regional integration is considered as a mean to facilitate the integration of ACP countries into the globalization in such a way of maximizing and reaping off the benefits from the Multilateral Trading System (MTS). In this context, Ethiopia has embarked on the EPA negotiations with the EU within the Eastern and Southern Africa (ESA) Regional Economic Community. Yet, two challenges may arise from this negotiating configuration: the issue of ratification of the EPA and the issue of the rationalization of the RECs. Both issues could introduce unnecessary tensions within the RECs. The former would introduce some tensions about the decision of the level of the ratification (regional or national level). The latter would force some RECs to rationalize in spite of major local political issues.

Phase II of the negotiations' process is currently going on at the regional level. This phase was launched in early 2004 for Eastern and Southern Africa region. Within this crucial phase of the negotiations, each REC and each country should be aware about the expected outcome of the EPA on their own economy. While many benefits are expected from these EPAs, many challenges need to be clarified, analyzed and taken into account during the preparation of negotiating position by each REC and each country.

Given this background, this study provides an in-depth analytical work aimed at assessing the impact of the EPA on Ethiopia's economy in order to ensure maximum benefits from the ongoing EPA negotiations with the EU. What would be the impact of the EPA on Ethiopia? What would be the impact of the EPA for Ethiopia within the COMESA? Would the entry of Ethiopia in the Free Trade Area of COMESA be beneficial? To what extent would the EPA lead to a surge in European imports? How bad would the trade

diversion be, leading to negative consequences for the regional partners of Ethiopia? What would be the costs (in terms of trade balance and public revenues) and the gains (total welfare) for the country?

In order to shed some light on these numerous issues, this study endeavors to quantify economic and social impacts of the trade liberalization aspects proposed by the EPA for Ethiopia. More precisely, this study will provide on the one hand a quantitative assessment of the likely implications of the EPA. On the other hand, since Ethiopia envisages entering the Free Trade Area of the Common Market for Eastern and Southern Africa (COMESA), this study contributes to the analysis of the implications of Ethiopia's participation to this regional integration scheme. The paper is organized in six different sections. Following the introductory section that presented the background of the EPA negotiations, section 2 analyses the recent trends of the Ethiopian economy, as well as the trade features of the country. The third section covers the empirical and technical work. Four different scenarios are tested through the simulations undertaken with the model developed by the World Bank and the United Nations Conference on Trade and Development, WITS/SMART<sup>2</sup>:

- Scenario I: Ethiopia is engaged in a full trade liberalization with the EU.
  - Scenario II: Ethiopia is engaged in a partial trade liberalization: full reciprocity on agricultural products.
  - Scenario III: Ethiopia is engaged in a partial trade liberalization: full reciprocity on industrial products.
  - Scenario IV Ethiopia is engaged in a full trade liberalization with the EU and the COMESA.
- The fourth section will present and discuss the results of the empirical study. The fifth section will discuss the necessary adjustments costs that could accompany such EPA. The sixth and last section will provide the conclusions and recommendations of the study.

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2. The model is briefly described in the introduction of the third part, and more detailed in the annexes.

## II. Economic and trade environment in Ethiopia

### 2.1 Economic environment

During the last fifteen years, Ethiopia has conducted several economic reforms. The country began the 1990s with a clear vision of reversing the socio-economic crisis of the 1980s and rapidly transforming the economy. In 1992/93, the government began its first series of economic reform programs. The reform program were aimed at reorienting the economy from command to market economy, rationalizing the role of the state and creating legal, institutional and policy environment to enhance private sector investment. However, the long-term outlook for the Ethiopian economy is still precarious. With high structural public and trade deficits, the Ethiopian recovery relies heavily on international aid. In this regard, it is important to make sure that the ensuing trade regime induced by the Free-Trade Area with the EU will not lead to a destabilization of the public and external accounts. Furthermore, this EPA needs to support and strengthen the development strategy of the Ethiopian government.

Ethiopia has a number of peculiar characteristics, which include a high demographic and ecological diversity, an extremely high rate of absolute poverty and economic insecurity and a predominantly subsistence and coffee-based monocrop economy. The country with a population of over 70 million in 2003<sup>3</sup> is the third most populous country in Africa. Yet, the majority of the population lives in absolute poverty. The primary notable achievement in Ethiopia in the early 1990s was the end of internal conflict followed by a successful transition made towards peace and democracy. Since then, a federal system of government has been put in place. The adoption of Agricultural Development Led Industrialization Strategy (ADLI) provided long-term development framework for economic transformation<sup>4</sup>.

Adjustment policies focused on liberalization of prices and markets, removal of subsidies, reduction of tariffs, and current account convertibility. These were buttressed with fiscal and monetary policy discipline. The favorable policy environment created by the economic reform, coupled with macro-economic stability, invigorated the domestic private sector, which was suppressed during the *Derg* period. The smallholder farming family was made the focus of economic development with a massive agricultural extension and credit scheme, and expansion of primary education, primary health care, rural water supply and rural roads. Macroeconomic indicators of the performance of the economy during the 1990s give an overall picture of a declining trend of poverty. GDP grew at an annual average rate of close to 5% during 1992/93-2000/01, with sectoral growth rates of 2.5% for agriculture, 5.3% for industry, 6.3% for distributive services (i.e. transport and communication trade and tourism), and 8.2% for “other”

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3. Population estimation taken from <http://www.unfpa.org/profile/compare.cfm>

4. Federal Democratic Republic of Ethiopia (2002), **Ethiopia: Sustainable Development and Poverty Reduction Program**, Ministry of Finance and Economic Development.

services. Within agriculture, crop sub sector, had registered an annual average growth rate of 4.9% during 1992/93-2000/01. Inflation, another important variable affecting poverty stood generally at a low rate and has been checked on average within single digits (below 5%) from pre-reform two years level of 21%. During the period 1992/93-2001/02, GDP per capita has been growing by 2.4% per annum. Though still low, such a growth in per capita terms is believed to be encouraging given the situation Ethiopia was in during the last two years of the late 1990s, notably weather related shocks, Ethio-Eritrea border conflict and major terms of trade loss. The sharp increase in the productivity of crop production within the areas of reliable rainfall contributed towards improvement in the performance of the agricultural sector. Notwithstanding the negative effect of adverse climatic changes on total crop output and prices, the upward trend of crop production, which occurred in the 1990s, helped to secure a relatively low rate of inflation for most of the period. Parallel to this, the growth of exports, following the economic reform, coupled with the moderate balance of payment support the country obtained, helped to maintain a relatively stable exchange rate regime.

With respect to foreign direct investment (FDI), the Government's commitment in creating conducive environment notably of liberal investment code, opened the way for attracting capital, technology and know-how. Over the period 1995/96 to 2000/01, 262 foreign investment projects received certificate, of which 56 have become operational. Ethiopia has made every effort possible to put in place an investment code in which measures for attraction, protection and guarantees of foreign and domestic private investment have been codified.

## **2.2 Evolution of trade policies**

Ethiopia like most African countries had been following interventionist and heavy protectionist policy during the reign of the socialist *Derg's* regime (1974-1991). In the case of Ethiopia, the major motive for such policies was to maximize government revenue through tax, so as to maintain the balance of payments at sustainable level and also to control and extinct the private sector (Befekadu and Berhanu 1999/2000). Moreover, the *Derg's* regime strengthened protectionist policy through exchange rate pegging to the US dollar for a long period of time, curtailed imports through imposing quotas, high tariff rates (230 %) and lengthy import licensing procedures. Exporters were also forced to surrender 100% of their foreign exchange earnings. Both external sector activities were performed through government marketing channels. According to Alem (1995), the *Derg's* trade regime and exchange rate policies were effective in depressing incentives to export production than repressing import demand, which consequently led to a persistent BOP deficit. An equivalent tariff of 71% in 1977, for instance, had led to a 43.5% fall in relative prices of coffee, while giving average "true" protection of only 27.3% for import competing sector.

In 1991/92, Ethiopia pursued the Structural Adjustment Program initiated by the World Bank and the International Monetary Fund. As the major component of the structural adjustment programs, trade reforms were adopted as a central lever of the free market strategy in order to obtain financial support to pull out the country from its entrenched poverty. The new development strategy involved diverse actions: deregulation of domestic prices, liberalization of foreign trade, privatization of public enterprises, the gradual abolition of export subsidies and taxes, devaluation of the national currency (the birr) and significant reduction in tariffs and non tariff barriers. Since the beginning of the 1990s, Ethiopia has been making significant progress toward opening up its economy and has notably improved its trade policy regime (Subramanian, 2002). More specifically, the trade reforms implemented resulted in a significant cut in import tariff rates, a reduction of the tariff dispersion and a decrease in the level of applied rates. At present, the country's trade protection system includes no quotas, no seasonal tariffs and no tariff contingent, and quantitative restrictions have been almost entirely eliminated. Currently, they are applied only to used clothes and for security and safety reasons.

The major improvements on trade policy include the significant reductions in the number of items included in the negative list used to determine import eligibility for foreign exchange access, as the conversion of the most specific tariffs into *ad valorem* rates. Currently, specific rates are used only for less than 3% of total tariff lines. Consequently the current Ethiopia tariff structure is roughly fully consolidated. In other words, a very large majority of import duties and taxes has been set in the external tariff. Likewise, as a result of the tariff reform, the range narrowed from 0% to 240% at the beginning of the 1990s to 0% to 80% in 1995. The current tariff structure, introduced in 2003, consists of six rates, 0%, 5%, 10%, 20% and the highest 35%. During the same period, the tariff bands (the number of official tariff rates) were reduced from 23 to 6. It is important to note that the current rates are very close to those that will be used for the common external tariff of COMESA's customs Union (CU), when the maximum rate will be 30%. Therefore, joining the regional CU should not be a very difficult process for Ethiopia, at least as regards the common external tariff (CET) implementation aspect. As is often the case, the range of the rates in relation to the types of products to which they are applied follows an ascending tariff system (tariff escalation), which is likened, to the amount of processing undergone by the products in the country. The lowest tariff levels are mainly applied to capital goods, while the highest are reserved to consumer good. The COMESA study illustrates this point, showing that the average tariff rate for capital goods is 12%, while raw materials, intermediate goods and finished consumer goods carry an average rate of 15%, 15.5% and 28% respectively (COMESA, 2003 as quoted in MOTI, 2004). Therefore, the effective protection for some goods is above the nominal protection. The Integrated Framework's Diagnostic Trade Integration Study (DTIS) compared nominal and effective protection in Ethiopia, stating that a "weighted average rate of (nominal) protection of 22.2 percent in 1995 was associated with an effective protection level of 36.2 percent. The comparable figures for 2001 were 14.7% and 26.0% respectively" (DTIS, 2004).

## 2.3 Ethiopia's trade performance

### Exports structure and performance

Like most of the Least Developed Countries (LDCs) in Africa, Ethiopia exports few commodities that are mainly primary goods in the international market. Indeed, around 80% of total exports comprised agricultural and food products over the period 1995-2002. Leather and leather products, textiles and garments represented 17%, while mining products represented 2%. Among the agricultural exports, coffee represented as much as 50% in 2002, followed by vegetable products (13%) and dried beans (12%), sesame seed (12%) and raw cane sugar (6%) (Chane Kune, Abbate, Deneke, Deressa, 2004). The five major partners of Ethiopia in terms of exports were respectively in decreasing order the EU, Djibouti, Japan, Saudi Arabia and the United States since 1995. Over the period 1995-2002, the EU, within which Italy, Germany and the United Kingdom represented the major players, remained the first buyer of Ethiopian exports. The export structure has experienced some limited improvements in terms of products and destination diversification as well as in terms of higher degree of processing (Chane Kune and Al., 2004). Regarding exports performance, export as a share of GDP has slightly decreased after liberalization in 1990. Similarly, the ratio of export to import has declined. Yet, the average growth rate of export earnings shows a significant improvement after trade liberalization. (Chane Kune et. Al., 2004).

### Import structure and performance

During the period 1995-2002, Ethiopia's imports were composed of capital and consumer goods. These products are mainly processed goods such as machinery and equipment, chemicals, mainly fertilizers (urea, ammonium) and tyres, as well as petroleum and its by-products. Ethiopia's imports originated from five major partners: the EU, China, the United States, the United Arab Emirates and Japan. The EU share in Ethiopia's imports included machinery and transport equipment. Within the EU, Italy, Germany and the United Kingdom were respectively the first three suppliers of European goods to Ethiopia. At the regional level, Kenya, Egypt and Djibouti were the three most important partners within COMESA. Over this period, Ethiopian imports have generally increased in terms of average import values and average import growth rate, and the EU remained the first partner.

Finally, it can be observed that Ethiopia's trade is concentrated on the EU market according to its exports and imports structure. Ethiopia is dependent on a few primary commodities such as coffee, whose prices are volatile and renders the local economy vulnerable. As well, the country faces very high transport costs and has weak institution to facilitate trade. In this context, Ethiopia needs to improve its benefits from international trade through an increased diversification of exports and partners and through a higher level of processing. These elements should be taken into account during the negotiations of the EPA. Further, Ethiopia could benefit from more trade with the other African countries and specifically with the COMESA members.



### III. Trade simulations on the Economic Partnership Agreements reform

The Economic Partnership Agreement will enable the EU and the ACP countries to continue their cooperation in compliance with the WTO regulations, especially with the article XXIV of the GATT. After the implementation of the EPAs, the EU and ACP countries would have formed a free trade area, leading to a full liberalization of the trade between these two regions. Article XXIV of the GATT leaves room to the WTO members in terms of product coverage. In principle, all the products shall be included in the free-trade agreement. In practice however, a free trade agreement does not necessarily have to fully comply with this rule. Thus, after the free trade agreement of 1999 between South Africa and the EU, South Africa has liberalized only 86% of the European imports, while the EU has liberalized 95% of South African imports<sup>5</sup>.

#### Ethiopia in EU-ESA EPA

Ethiopia is one of the sixteen countries under the Eastern and Southern Africa (ESA) grouping led by the COMESA Secretariat, which has agreed to negotiate the Economic Partnership Agreement (EPA) with the European Union (EU).

In 2000, nine COMESA member-states<sup>6</sup> signed a Free Trade Area (FTA) protocol that provides for variable speed to allow other countries to make the necessary adjustments before joining. Ethiopia is one of the countries expected to join the FTA before the EPA enters into force by 1 January 2008. It's also possible that at this date the COMESA will be a Customs Union.

In this regard, four different scenarios will be tested, to assess the total effect of the EPAs on the Ethiopian economy, as well as the likely aftermath of a partial liberalization:

- A general scenario, based on full liberalization of all the imports from the EU to Ethiopia.
- A scenario limited to the liberalization of the agricultural imports from the EU.
- An industrial scenario, assessing the impact of free trade limited to industrial goods.
- A general scenario, based on full liberalization of all the imports from the EU and from the COMESA countries to Ethiopia.

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5. Source: discussion paper number 60 of the European Center for Development Policy Management.

6. Initial FTA countries are Djibouti, Egypt, Kenya, Madagascar, Malawi, Mauritius, Sudan, Zambia and Zimbabwe, which were joined last year by Burundi and Rwanda.

In order to realize these simulations, we have used the WITS/SMART model<sup>7</sup>.

## Scenarios definition and empirical results

### **3.1 Full liberalization of all the imports from the EU to Ethiopia**

In this scenario, we focused on the effect of the tariff cuts on all the sectors. This scenario aims to give an impact evaluation in terms of fiscal revenue losses, trade creation, trade diversion and welfare of the tariffs complete removal. This scenario is expected to provide the magnitude of the adjustment cost in terms of fiscal revenue losses, as it doesn't include any sensitive product.

#### **Trade**

The EPA will distort the Ethiopian imports towards European countries, to the detriment of the regional trading partners of Ethiopia.

Due to the EPAs reform, exports from the EU to Ethiopia will **gain** by more than 33%, from \$ 456 million to \$ 608 million. This increase, which is not very significant, at the level of the EU, changes the structure of imports of Ethiopia: the share of the EU among exporters would increase to the disadvantage of other Ethiopia's partners.

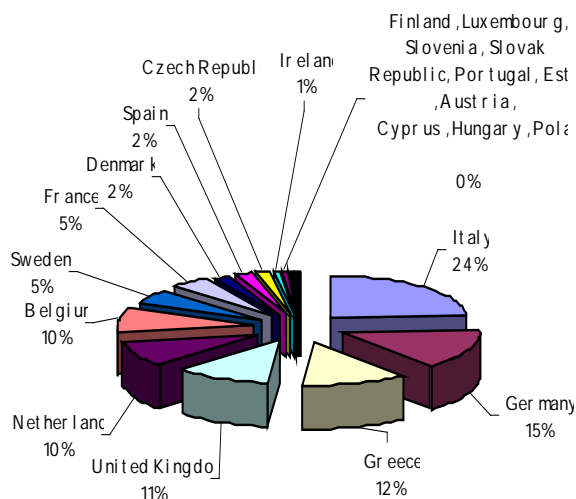
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7. "The World Integrated Trade Solution (WITS) brings together various databases ranging from bilateral trade, commodity trade flows and various levels and types of protection. WITS also integrate analytical tools that support simulation analysis. The SMART simulation model is one of the analytical tools in WITS for simulation purposes. SMART contains in-built analytical modules that support trade policy analysis such as effects of multilateral tariff cuts, preferential trade liberalization and ad hoc tariff changes. The underlying theory behind this analytical tool is the standard partial equilibrium framework that considers dynamic effects constant. Like any partial equilibrium model, it has these strong assumptions allowing the trade policy analysis to be undertaken a country at a time". Source "The analytical Methodology – The GTAP and SMART models and related databases", S. Karingi, ECA, TRID, 2004, Mimeo.

**Table 1: Value of exports of the EU to Ethiopia (\$'000)**

Exporter	Before	After	Change	%
<b>Total</b>	<b>455 913</b>	<b>607 740</b>	<b>151 827</b>	<b>100%</b>
Italy	140 297	176 272	35 975	23.69%
Germany	69 341	92 473	23 132	15.24%
Greece	16 240	35 061	18 820	12.40%
United Kingdom	57 243	74 569	17 326	11.41%
Netherlands	38 676	53 898	15 222	10.03%
Belgium	40 332	54 832	14 500	9.55%
Sweden	29 071	36 717	7 646	5.04%
France	25 506	32 466	6 960	4.58%
Denmark	10 318	13 498	3 179	2.09%
Spain	9 423	12 286	2 864	1.89%
Czech Republic	2 811	5 320	2 510	1.65%
Ireland	4 403	5 503	1 100	0.72%
Finland	2 458	3 169	711	0.47%
Austria	4 322	4 917	595	0.39%
Cyprus	1 751	2 123	372	0.25%
Poland	1 716	2 028	312	0.21%
Hungary	766	1 073	307	0.20%
Slovenia	729	908	179	0.12%
Portugal	463	560	97	0.06%
Slovak Republic	41	56	15	0.01%
Estonia	6	10	4	0.00%
Luxembourg	7	10	3	0.00%

Source: WITS/SMART Model.



The net imports increase is expected to be around \$120 million. This amount is not negligible as it represents around 7.5% of Ethiopia level of import in 2002. This evolution of the imports introduces a bias, which appears to be unfavourable for at least two reasons:

- It weakens the regional integration efforts, as COMESA countries are significantly losing from the agreement (see Table 3) to the benefit of the EU countries (especially Italy, Germany and Greece).
- It reinforces competitors that produce value added goods.

As shown in table 2, most products imported from the EU relate to vehicles, but also furniture (bedding, mattress...), boilers and electrical machinery, sectors that Ethiopia and its COMESA partners could develop. Thus, Kenya that has been developing light industries producing small electrical equipment as well as car spare parts could have its diversification strategy hampered by the EPAs reform.

Table 2: Growth of traded volumes after EPAs (\$'000)

Product	Changes After EPAs
Total All products	120679
HS.87 Vehicles o/t railw/tramw roll-stock, pts & access	29,791.85
HS.94 Furniture; bedding, mattress, matt support, cushi	23,723.24
HS.84 Nuclear reactors, boilers, mchy & mech appliance;	14,256.06
HS.85 Electrical mchy equip parts thereof; sound record	11,129.65
HS.90 Optical, photo, cine, meas, checking, precision,	6,134.18
HS.40 Rubber and articles thereof.	3,821.54
HS.82 Tool, implement, cutlery, spoon & fork, of base m	2,898.74
HS.39 Plastics and articles thereof.	2,718.06
HS.73 Articles of iron or steel.	2,714.49
HS.30 Pharmaceutical products.	2,698.81
HS.19 Prep.of cereal, flour, starch/milk; pastrycooks'	1,788.30

Source: WITS/SMART Model

The global trade diversion amounts to \$31.16 million, which is limited as regards to the global level of trade for Ethiopia. However, this trade diversion is affecting COMESA trading partners of Ethiopia as well as other African economies outside COMESA such as South Africa. The intra-COMESA loss of trade would amount to \$3.6 million, while intra-African trade would fall only by \$1.03 million. These losses are concentrated on three major product categories: vehicles and transport equipment (HS 87, \$1.7 million)<sup>8</sup>, essential oils and cosmetic (HS 33, \$0.2 million), boilers from South Africa and Kenya (HS 84, \$0.2 million), Electrical machinery equipments from Egypt (HS 85, \$0.1 million) and diverse agricultural products (among which HS 11, \$0.1 million).

The main important source of the trade diversion is Asia with \$19 million within the \$26.5 million for all the rest of the world. UAE (while noting that a large part of the UAE imports are in fact coming from other Asian countries), Japan, India and China are likely to lose around \$15 million of their exports to the Ethiopian Market.

Table 3: Trade diversion from Ethiopia – EU EPAs (\$'000)

Exporter to Ethiopia	Export
	Diversion
<i>Total COMESA</i>	-3611
Djibouti	-2385
Kenya	-497
Egypt	-341
<i>Total Rest of Africa</i>	-1029
South Africa	-873
Niger	-51
<i>Total Rest of the World</i>	-26512
United Arab Emirates	-5668
Japan	-4372
United States	-3746
India	-2566
China	-2545
<b>Total export diversion</b>	<b>-31152</b>

Source: WITS/SMART Model

8. But this diversion concerns the car sellers in Djibouti. So for this product it is more an Ethiopian fiscal issue than a Djiboutian industrialization question.

## Trade diversion from COMESA

Table 4: Diversion of exports from COMESA by main products (\$'000)

Details in annexes

Product	Change after EPAs	%
Djibouti: total change in exports	-2385	100
HS.87 Vehicles o/t railw/tramw roll-stock, pts & access	-1690	71
HS.21 Miscellaneous edible preparations.	-94	4
HS.84 Nuclear reactors, boilers, mchy & mech appliance;	-72	3
HS.04 Dairy prod: birds' eggs: natural honey: edible pr	-65	3
Kenya: total change in exports	-497	100
HS.15 Animal/veg fats & oils & their cleavage products;	-86	17
HS.84 Nuclear reactors, boilers, mchy & mech appliance;	-58	12
HS.30 Pharmaceutical products.	-56	11
HS.19 Prep.of cereal, flour, starch/milk; pastrycooks'	-40	8
HS.33 Essential oils & resinoids; perf, cosmetic/toilet	-36	7
HS.94 Furniture; bedding, mattress, matt support, cushi	-32	7
HS.87 Vehicles o/t railw/tramw roll-stock. pts & access	-22	5
Egypt. Arab Rep.: total change in exports	-341	100
HS.85 Electrical mchy equip parts thereof; sound record	-132	39
HS.94 Furniture; bedding, mattress, matt support, cushi	-44	13
HS.30 Pharmaceutical products.	-35	10
HS.39 Plastics and articles thereof.	-35	10
HS.40 Rubber and articles thereof.	-25	7

Source: WITS Smart Model, Details in annexes.

As indicated in table 3, this scenario undermines regional integration within COMESA. Djibouti, Kenya and Egypt seem to be the biggest losers after simulating the agreement, although the losses are not significant considering the level of exports of these countries<sup>9</sup>. EPAs, in terms of trade creation of business, are favourable to the EU. The fact that intra-COMESA trade can be affected in a negative

9. In 2003, Kenya exported USD 2.4 billion of goods, and Egypt USD 5 billion. However, this amount is not negligible for Djibouti, which exported USD 63 million. Source UNCTAD.

way constitutes a subject of concern for the process of regional integration. Furthermore, due to the type of exports concerned, manufactured goods (particularly transport equipment and agro industrial products), it is more alarming. Not only do the EPAs imply that trade integration within COMESA will be hampered, but the diversification strategy of the concerned countries is also affected negatively. Thus the consequences of this agreement could raise serious concern about its consequences in terms of development.

## Trade diversion from the rest of Africa

Table 5: Diversion of exports from the rest of Africa by main products (\$'000) Details in annexes

Product		Changes after EPAs	%
<b>South Africa: total change in exports</b>		<b>-873</b>	<b>100</b>
HS.33	Essential oils & resinoids; perf. cosmetic/toilet	-176	20
HS.84	Nuclear reactors, boilers, mchy & mech appliance;	-141	16
HS.22	Beverages, spirits and vinegar.	-56	6
HS.87	Vehicles o/t railw/tramw roll-stock, pts & access	-49	6
HS.94	Furniture; bedding, mattress, matt support, cushi	-40	5
HS.90	Optical, photo, cine, meas, checking, precision,	-40	5
HS.30	Pharmaceutical products.	-40	5
HS.82	Tool, implement, cutlery, spoon & fork, of base m	-38	4
HS.85	Electrical mchy equip parts thereof; sound record	-36	4
<b>Niger: total change in exports</b>		<b>-51</b>	<b>100</b>
HS.22	Beverages, spirits and vinegar.	-21	42
HS.87	Vehicles o/t rail/tram roll-stock, pts & access	-18	35
HS.30	Pharmaceutical products.	-6	11
HS.90	Optical, photo, cine, meas, checking, precision,	-4	9
HS.40	Rubber and articles thereof.	-1	3
<b>Senegal: total change in exports</b>		<b>-35</b>	<b>100</b>
HS.87	Vehicles o/t rail/tram roll-stock, pts & access	-10	27
HS.85	Electrical machine equip parts thereof; sound record	-9	26
HS.90	Optical, photo, cine, meas, checking, precision,	-9	25
HS.30	Pharmaceutical products.	-3	8

Source:: WITS Smart Model, Details in annexes.

The product analysis reveals that the exports' losses concern sensitive products for the industrial development of these African countries. In South Africa, Niger and Senegal, the losses would affect a lot of emerging industrial sectors.

Ethiopia will benefit from a limited gain of consumer welfare compared to significant public revenues losses.

Ethiopia, like the majority of ESA countries, has substantial reliance on import duties as a source of government revenues. This reliance on trade tariffs might at times be a serious binding constraint to development activities in situations where the concentration of the source of these revenues is in a few countries' imports. The EU serves as a significant source for Ethiopia's imports and is therefore a major component of the import taxes base. The elimination of the import tariffs on EU-sourced imports is therefore an important factor in the economic analysis of EPAs.

EPA will act as a quasi FTA between ESA countries and the EU. As such, it will lead to a drop in the customs revenues on the imports from the EU. The elimination of this fiscal source will imply either finding new fiscal basis in Ethiopia, or cutting public expenditures. Replacing tax revenues is a sensitive issue. In this perspective, Baunsgaard et al. (2004) have demonstrated that most low-income countries have not been able to replace trade tax revenue losses with other revenue sources.

The fiscal losses have two sources: the fiscal loss on trade diverted from non-EU countries, and the fiscal loss induced by the tax exoneration of imports from the EU. The total fiscal loss amount is expected to be around \$55 million. This fiscal loss, which is limited in respect of the Ethiopian GDP (\$6.5 billion in 2003<sup>10</sup>), amounts to 4 percent of the Ethiopian government revenues in 2002/2003, and 12.5 percent of import duties in 2002/2003. Indeed, the EPAs' reform would contradict a major development orientation of Ethiopia through a long-term strategy of Agricultural Led Industrialization (ADLI), which emphasizes on the diversification of the economy.

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10. UNCTAD Handbook of Statistics.



Table 6: Tariff Revenues losses by line of products (\$'000)

Product	Tariff revenues losses	%
Total tariff revenues variation	<b>-55126</b>	<b>100</b>
HS.87 Vehicles o/t railw/tramw roll-stock, pts & access	-11826	21
HS.84 Nuclear reactors, boilers, mchy & mech appliance:	-8618	16
HS.85 Electrical mchy equip parts thereof; sound record	-5525	10
HS.94 Furniture; bedding, mattress, matt support, cushi	-4949	9
HS.90 Optical, photo, cine, meas, checking, precision,	-3091	6
HS.73 Articles of iron or steel.	-1868	3
HS.19 Prep of cereal, flour, starch/milk; pastrycooks'	-1827	3
HS.30 Pharmaceutical products.	-1605	3
HS.10 Cereals	-1363	2
HS.22 Beverages, spirits and vinegar.	-1165	2
HS.33 Essential oils & resinoids; perf, cosmetic/toilet	-971	2

Source: WITS Smart Model, Details in annexes.

### Consumer welfare effect

In terms of consumer welfare, Ethiopia would record a net gain amounting to \$19 million, which is not very significant in regard of the Ethiopian GDP (0.003%). The consumers who would enjoy decreased prices, thanks to the reform of the EPAs, would capture this welfare. As import prices go down, consumers are able to consume more goods such as vehicles (HS 87) or furniture, bedding etc (HS 94) textiles, for the same income. Companies can also improve their competitiveness by accessing inputs at lower prices (electrical machinery equipments parts (HS 85)).

Table 7: Variation of Consumer Welfare by line of products (\$'000)

Product	Welfare	%
Total variation of consumer welfare	19029.481	100
HS.87 Vehicles o/t railw/tramw roll-stock, pts & access	5,350.61	28
HS.94 Furniture: bedding, mattress, matt support, cushi	4,956.31	26
HS.85 Electrical mchy equip parts thereof; sound record	1,632.77	9
HS.84 Nuclear reactors, boilers, mchy & mech appliance;	1,058.17	6
HS.90 Optical, photo, cine, meas, checking, precision,	764.119	4
HS.40 Rubber and articles thereof.	613.589	3
HS.19 Prep.of cereal, flour, starch/milk; pastrycooks'	493.945	3
HS.82 Tool, implement, cutlery, spoon & fork, of base m	475.698	2
HS.39 Plastics and articles thereof.	450.697	2

Source:: WITS/SMART Model, Details in annexes.

However the consumer welfare improvement of \$19 million is not very high compared to the tariff revenue losses, which are estimated at more than \$55 million. Yet, it is advisable to be careful with this type of comparisons. Indeed, in the short run, this unfavorable result underlines the difficulties with which Ethiopia will be confronted but, no conclusion can be ascertained in the long run, given that these results ignore, not only, the various interactions linked to this type of liberalization, but also the potential dynamic gains of such a process.

### 3.2 Sectoral approach (1): Agricultural scenario

In this scenario, we focused the tariff cuts on the agricultural sector only, leaving the Ethiopian industrial import tariffs unchanged. This scenario will permit to differentiate and assess the impacts of the EPA on the Ethiopian agricultural sector.

The growth of the EU trade is less significant (15 times less) than in the general scenario, due to the fact that the EU mainly exports industrial goods to Ethiopia. Ethiopia imports mainly industrial goods. The total trade effect (trade increase of EU exports less trade diversion from the rest of the world), amounts to \$6.18 million<sup>11</sup>, which may be seen as limited in volume but is still sensitive due to the sector concerned. As agriculture employs 85 % of the active population in Ethiopia, this increase could induce significant losses in terms of employment. Italy is the EU country that gains more in terms of new exports toward Ethiopia (46% of the new flows). Actually, this new flow represents 12.72% of the value in exports

11. Total trade effect = growth of the EU exports (USD 9.88 million) – trade diversion (USD 3.7 million)

gain Italy would have enjoyed in the full trade liberalization context (scenario 1). This could reflect that Ethiopian imports are mainly industrial goods. Similarly, we can note that the EU export gains in Ethiopia in the current scenario represents 6.50% of the EU total export gains in scenario 1.

Table 8: Value of EU exports growth to Ethiopia (\$'000)

EU exporter	EU exports change	%
Total export growth	9,881	100
Italy	4577	46
United Kingdom	1585	16
Belgium	1209	12
Netherlands	1007	10
France	511	5
Germany	507	5
Ireland	165	2

Source: ITS/SMART Model.

Furthermore, the increase in EU trade export appears partially to be as a result of trade diversion from African countries, meaning that EPAs reform focused on agricultural liberalization also contradicts one of the principles of the Cotonou Partnership Agreement on deepening integration. COMESA represents 13.5% of the trade diversion. However, this sub-regional trade diversion is highly concentrated on two countries, Djibouti and Kenya, which account for 96% of the COMESA trade diversion.

Table 9: Trade diversion from Ethiopia EU-EPA's (\$'000)

Exporter to Ethiopia	Export diversion	%
COMESA	-501	100
Djibouti	-331	66
Kenya	-148	30
Rest of the Africa	-158	100
South Africa	-126	80
Niger	-21	13
Egypt, Arab Rep.	-11	7
Rest of the World	-3045	100
United States	-2331	77
United Arab Emirates	-109	4

Source: WITS/SMART Model, details are available upon request.

Among the non-EU developed countries, the United States is most affected from such a scenario.

In the case of an agricultural scenario, the trade diversion share is higher than with the general scenario, as the part of trade growth for the EU resulting from trade diversion is higher. Thus, the share of the European trade growth induced by trade diversion would be equal to 37.5% of total gain, versus 20.5% in the previous scenario.

Table 10: Tariff Revenues losses by line of products (\$'000)

Product	Tariff revenues losses	%
Tariff revenues variation	-7385	100
HS.19 Prep.of cereal. flour. starch/milk; pastrycooks'	-1827	25
HS.10 Cereals	-1363	18
HS.22 Beverages, spirits and vinegar.	-1165	16
HS.24 Tobacco and manufactured tobacco substitutes	-701	9
HS.15 Animal/veg fats & oils & their cleavage products;	-516	7
HS.21 Miscellaneous edible preparations.	-512	7
HS.13 Lac; gums, resins & other vegetable saps & extrac	-474	6
HS.11 Prod.mill.indust; malt; starches; inulin; wheat g	-347	5
HS.04 Dairy prod; birds' eggs; natural honey; edible pr	-225	3

Source: WITS/SMART Model, details in annexes.

Given the net trade flow generated (\$6.18 million) and the welfare gain (\$1.15 million), the cost for Ethiopia in terms of tax loss is very significant in comparative terms. Even though it represents only one percent of the public revenues, this loss would increase the dependency of Ethiopia on international aid and raise questions about the solvency of its economy, for very limited gains. Alternative solutions to limit the public deficits induced by EPAs (reducing expenditures, increasing rates of other taxes and improved tax administration) could be considered, but will not be easy to achieve. It could be difficult for Ethiopia to accept such a situation, especially in the cases where some of these European products benefit from subsidies that render the competition on this market particularly unfair.

Table 11: Variation of Consumer Welfare by line of products (\$'000)

Product	Welfare changes	%
Variation of Consumer Welfare	1146	100
HS.19 Prep.of cereal, flour, starch/milk; pastrycooks'	494	43
HS.22 Beverages, spirits and vinegar.	185	16
HS.15 Animal/veg fats & oils & their cleavage products;	127	11
HS.24 Tobacco and manufactured tobacco substitutes	92	8
HS.21 Miscellaneous edible preparations.	69	6
HS.13 Lac; gums, resins & other vegetable saps & extrac	55	5
HS.04 Dairy prod; birds' eggs; natural honey; edible pr	35	3
HS.11 Prod.mill.indust; malt; starches; inulin; wheat g	23	2
HS.10 Cereals	20	2

Source: WITS/SMART Model details in annexes .

The consumer welfare perspective shows that Ethiopia has little to gain from opening up in favour of the agricultural products. Compared to the Ethiopian GDP, a welfare increase of \$1.1 million is not significant. The group of products which contributes the most (43 %), in this welfare gain will be the preparation of cereals, flours etc (HS 19). Beverage, spirits and vinegar and animal/vegetable fats and oil will also contribute significantly to the welfare increase. However, even if this price reduction in the imports can have an impact on food consumers' procurement, and then on poverty, we have to keep in mind that 85% of Ethiopian labour force is concentrated on agriculture.

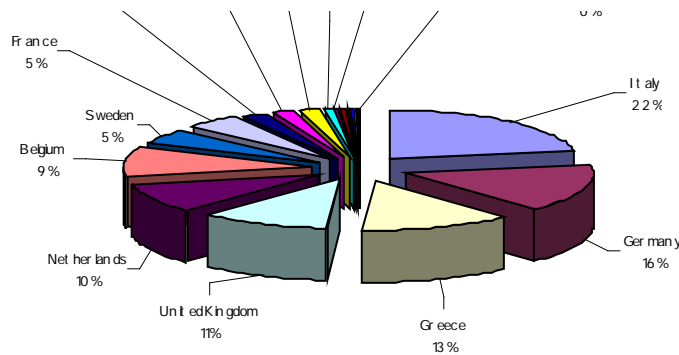
### 3.3 Sectoral approach (2): Industrial scenario

In this scenario, we focused the tariff cuts on the industrial sector only, leaving the agricultural import tariff of Ethiopia unchanged. This scenario offers a similar perspective than the general scenario, which confirms that the trade gain resulting from liberalization would be concentrated on industrial products.

Table 12: Value of EU exports growth to Ethiopia (\$'000)

EU exporter	EU exports change	%
Export growth	141949	100
Italy	31398	22
Germany	22625	16
Greece	18695	13
United Kingdom	15741	11
Netherlands	14215	10
Belgium	13291	9
Sweden	7639	5
France	6449	5

Source: WITS/SMART Model, details in annexes.



In terms of exports from the EU, the gap between this scenario and the initial one is equal to \$9.9 million. 19% of the increase in trade is due to trade diversion, mainly the one from Asian countries. Trade diversion from COMESA would account for 11 % of the diversion (3% for the African continent), while it accounts for more than 13.5% in the agricultural scenario (4% for the African continent). These results mean that the regional integration is more affected in their agricultural liberalisation component in term of percentage. However, in value terms, COMESA and the rest of Africa are losing nearly \$4 million in the industrial scenario, while they are losing only \$0.66 million in the agricultural one. The countries concerned by trade diversion are the same as in the initial scenario. Djibouti remains the main loser among the African countries. As noticed previously, vehicles are the products on which trade diversion is concentrated in the case of Djibouti.

Table 13: Trade diversion from Ethiopia EU-EPA's (\$'000)

Exporter to Ethiopia	Export diversion	%
COMESA	-3102.082	100
Djibouti	-2,053.81	66
Kenya	-348.906	11
Egypt, Arab Rep.	-329.918	11
Swaziland	-311.462	10
Rest of the Africa	-873.293	100
South Africa	-746.938	86
Senegal	-35.365	4
Niger	-29.556	3
Tunisia	-23.529	3
Rest of the World	-23468.518	100
United Arab Emirates	-5,559.46	24
Japan	-4,368.36	19
India	-2,535.66	11
China	-2,526.78	11
United States	-1,414.72	6
Saudi Arabia	-1,097.60	5

Source: WITS/SMART Model, details in annexes.

Tax revenue losses are significant as they represent around 3.5% of the public resources, which is all the more detrimental given that Ethiopia has not been able to balance its public budget over the last ten years. However the ratio of tax losses / consumer welfare is equal to 2.67, versus 2.9 in the general scenario and 6.44 in the agricultural scenario, meaning that EPAs reform would bring more consumer welfare for a given cost (\$1 tariff revenue loss) on industrial products than on agricultural products. In other words, the same level of consumer welfare would induce smaller public revenue losses with industrial scenario than with the agricultural one.

Table 14: Tariff Revenue losses by line of products (\$'000)

Product	Tariff revenues losses	%
Tariff revenue variation	-47741	100
HS.87 Vehicles o/t railw/tramw roll-stock, pts & access	-11,825.76	25
HS.84 Nuclear reactors, boilers, mchy & mech appliance;	-8,617.58	18
HS.85 Electrical mchy equip parts thereof; sound record	-5,525.12	12
HS.94 Furniture; bedding, mattress, matt support, cushi	-4,948.76	10
HS.90 Optical, photo, cine, meas, checking, precision,	-3,091.03	6
HS.73 Articles of iron or steel.	-1,867.68	4
HS.30 Pharmaceutical products.	-1,604.84	3
HS.33 Essential oils & resinoids; perf. cosmetic/toilet	-971	2
HS.82 Tool, implement, cutlery, spoon & fork, of base m	-771	2
HS.48 Paper & paperboard; art of paper pulp, paper/pape	-768	2

Source: WITS/SMART Model, details in annexes.

The analysis of the consumer welfare results of industrial openness, reveals that the bulk of consumer welfare gain would result in the tariff cuts on the industrial imports from EU. On these products Ethiopian consumers are the more likely to benefit from decreases in prices. As in the first scenario the prices of vehicles (HS 87) or furniture, bedding etc (HS 94), will decrease. At the production level, companies can improve their competitiveness by accessing inputs at lower prices (electrical machinery equipments parts (HS 85)).

Table 15: Variation of Consumer Welfare by line of products (\$'000)

Product	Welfare variation	%
	17883	100
HS.87 Vehicles o/t railw/tramw roll-stock, pts & access	5351	30
HS.94 Furniture; bedding, mattress, matt support, cushi	4956	28
HS.85 Electrical mchy equip parts thereof; sound record	1633	9
HS.84 Nuclear reactors, boilers, mchy & mech appliance;	1058	6
HS.90 Optical, photo, cine, meas, checking, precision,	764	4
HS.40 Rubber and articles thereof.	614	3
HS.82 Tool, implement, cutlery, spoon & fork, of base m	476	3
HS.39 Plastics and articles thereof.	451	3
HS.33 Essential oils & resinoids; perf. cosmetic/toilet	276	2

Source: WITS/SMART Model, details in annexes.



### 3.4 Full liberalization with EU and COMESA

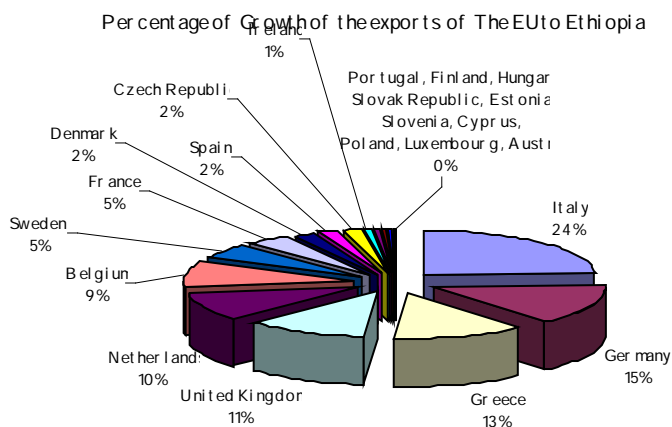
#### 3.4.1 Ethiopia opening its market to EU and COMESA

Deepening regional integration is one of the EPAs principles. This scenario is based on the initial one, but differs to some extent in that Ethiopia opens completely its market to European exports and also to COMESA countries exports. This double FTA scenario aims at providing an impact evaluation in terms of fiscal revenue losses (which is expected to be higher than in the first scenario), trade creation, trade diversion and consumer welfare. This scenario is expected to provide the magnitude of the adjustment cost in terms of fiscal revenue losses, as it does not include any sensitive product.

Table 16: Value of EU exports growth to Ethiopia (\$'000)

EU exporter	Exports change	Percentage
Export growth	149322.874	100
Italy	35470.366	23.75414098
Germany	22638.357	15.16067592
Greece	18775.079	12.57347819
United Kingdom	17115.272	11.46192244
Netherlands	14799.836	9.911298653
Belgium	14154.349	9.479022618
Sweden	7525.639	5.039843393
France	6810.2	4.560721219
Denmark	3098.979	2.07535451
Spain	2788.972	1.867745996
Czech Republic	2507.39	1.679173413

Source: WITS/SMART Model, details in annexes.



In this scenario, exports from the EU to Ethiopia will increase by more than 32%, from \$ 456 million, to \$ 605 million, similarly to the first scenario. This increase changes the structures of imports of Ethiopia: the share of the EU among exporters would increase to the detriment of other Ethiopia's partners, but not against COMESA countries exports. As in the first scenario, Italy, Germany, Greece and UK are the principal beneficiaries.

Table 17: Value of COMESA exports growth to Ethiopia (\$'000)

ESA exporter	Exports change	%
Export growth	27714	100
Djibouti	21231	77
Kenya	6941	25
Sudan	148	1
Zimbabwe	134	0
Uganda	26	0
Madagascar	22	0
Zambia	14	0
Seychelles	8	0
Malawi	6	0
Rwanda	6	0
Comoros	1	0
Congo, Rep.	0	0
Namibia	-6	0
Swaziland	-323	-1
Egypt, Arab Rep.	-496	-2

Source: WITS/SMART Model.

COMESA countries are the other beneficiaries in this scenario. With \$21 million increase, Djibouti is the country, which gains the most. Kenya also registers an increase of its exports by nearly \$7 million.

Table 18: Net import increase in Ethiopia (\$'000)

Product	Import changes	%
	140947	100
HS.87 Vehicles o/t railw/tramw roll-stock, pts & access	39095	28
HS.94 Furniture; bedding, mattress, matt support, cushi	24045	17
HS.84 Nuclear reactors, boilers, mchy & mech appliance;	14576	10
HS.85 Electrical mchy equip parts thereof; sound record	11702	8
HS.90 Optical, photo, cine, meas, checking, precision,	6240	4
HS.40 Rubber and articles thereof.	4423	3
HS.39 Plastics and articles thereof.	3189	2
HS.82 Tool, implement, cutlery, spoon & fork, of base m	2966	2
HS.73 Articles of iron or steel.	2844	2
HS.30 Pharmaceutical products.	2812	2

Source: WITS/SMART Model, details in annexes.

The net increase of Ethiopian imports is more than \$140 million (\$120.7 million in the first scenario). 28% of this increase concern vehicles (HS 87) and especially those from Djibouti. However, furniture, bedding, mattress (HS 94), boilers (HS 84) and electrical machinery equipments (HS 85) register also significant increase.

Table 19: Trade diversion (\$'000)

Exporter to Ethiopia	Export diversion	%	% cumul
Rest of the Africa	-1214	100	
South Africa	-1042	86	86
Niger	-57	5	90
Senegal	-37	3	94
Tunisia	-26	2	96
Rest of the World	-34874	100	
United Arab Emirates	-7119	20	20
Japan	-6238	18	38
United States	-4181	12	50
China	-3473	10	60
India	-3350	10	70

Source: WITS/SMART Model, details in annexes.

With \$27.4 million of \$34.9 million, most of the trade diversion is to the disadvantage of Asian countries. With \$4.2 million losses, the United States is one of the other losers in this scenario. The rest of the African countries lose only \$1.2 million of exports. However, these losses are concentrated on South Africa (86%) and concern perfumes and cosmetics, boilers, vehicles and beverages, spirits and vinegar.

Table 20: Tariff Revenues losses by line of products (\$'000)

Product	Tariff revenues losses	%
Tariff revenues variation	-65738	100
HS.87 Vehicles o/t railw/tramw roll-stock, pts & access	-15993	24
HS.84 Nuclear reactors, boilers, mchy & mech appliance;	-8846	13
HS.85 Electrical mchy equip parts thereof; sound record	-5742	9
HS.94 Furniture; bedding, mattress, matt support, cushi	-5071	8
HS.90 Optical, photo, cine, meas, checking, precision,	-3171	5
HS.19 Prep.of cereal, flour, starch/milk; pastrycooks'	-2080	3
HS.73 Articles of iron or steel.	-1979	3
HS.30 Pharmaceutical products.	-1680	3
HS.10 Cereals	-1430	2
HS.34 Soap, organic surface-active agents, washing prep	-1348	2

Source: WITS/SMART Model, details in annexes.

The total fiscal loss amount is estimated to be nearly \$66 million. This fiscal loss amounts to 4.7% of the Ethiopian government revenues in 2002/2003. This very significant amount once again advocates for a very progressive dismantlement of the tariffs, which are faced by the imports from the EU. Ethiopia could for instance accede to the COMESA FTA fully before any significant opening up to the EU. The speed within which tax policy and administration changes can be effected to raise productivity of the other taxes to fill the shortfall from import taxes becomes a major determinant of the practicability of the reciprocal principle of the EPAs, given that Ethiopia will be also facing challenges of COMESA FTA and possibly accession to the WTO. The adjustment costs of undertaking tax policy and administration reforms are likely to weigh heavily on the Ethiopian economy. This is because the nature of these adjustment costs is such that they are not only financial, but involve also human resources. Administration of income taxes and consumption taxes such as the VAT are more human capital demanding than the administration of import duties. Moreover, the EPAs' generated revenue shortfalls will also have economic, social and political dimensions. The fact that these countries will need to resort to income and consumption taxes will introduce growth and equity issues. Policy makers will be faced with the unwelcome option of

having to rely on income taxes, which tend to have a more defined negative relationship with economic growth. On the aspect of equity, consumption taxes are likely to be more regressive, affecting the poor negatively compared to their effects on the high-income households. A long period of implementation will let the Ethiopian authorities improve their fiscal policy and recovery. Second, according to the fact that Ethiopia is going to join the COMESA's FTA, it is better to "postpone" the EU fiscal shock, after the COMESA one (which is smaller), in order to reduce the global amplitude. The implementation of the dismantlement on a long period can have another positive aspect. A tariff reduction leads automatically to a reduction of the revenues. However, depending on import demand elasticity, the tariff reduction can also lead to a strong increase of the imports, which in turn would increase the tariff revenues. Obviously, at the last stage (zero tariffs) of the dismantlement this effect will disappear. For example, in a 15 years dismantling period, this stage will be in 2023. It gives enough time to improve the fiscal policy, to deepen regional integration, and to build exports capacities and diversify the economy.

In terms of consumer welfare, this scenario will result in an increase that is estimated at \$22.4 million. These gains concern vehicles (HS 87), furniture, bedding, mattress (HS 94), boilers (HS 84) and electrical machinery equipments (HS 85). In this scenario, the ratio of tax losses / consumer welfare is equal to 2.9, like in the first general scenario.

Table 21: Variation of Consumer Welfare by line of products (\$'000)

Product	Welfare changes	%
Variation of consumer welfare	22420	100
HS.87 Vehicles o/t railw/tramw roll-stock, pts & access	6947	31
HS.94 Furniture; bedding, mattress, matt support, cushi	5003	22
HS.85 Electrical mchy equip parts thereof; sound record	1728	8
HS.84 Nuclear reactors, boilers, mchy & mech appliance;	1075	5
HS.90 Optical, photo, cine, meas, checking, precision,	777	3
HS.40 Rubber and articles thereof.	675	3
HS.39 Plastics and articles thereof.	564	3
HS.19 Prep.of cereal, flour, starch/milk; pastrycooks'	528	2
HS.82 Tool, implement, cutlery, spoon & fork, of base m	492	2
HS.34 Soap, organic surface-active agents, washing prep	469	2

Source: WITS/SMART Model, details in annexes.

### **3.4.2 Ethiopia potential exports to COMESA**

Until this point, the study's scenario has been focusing on the impact on Ethiopia's economy of a dismantlement of Ethiopian tariffs over imports from the EU and COMESA. However, Ethiopian exports to COMESA markets were still facing some tariffs. Therefore, it is also important to evaluate the Ethiopian potential gains, in terms of exports value, in the context of Ethiopia's accession to COMESA's FTA (i.e. Ethiopia benefiting from a dismantlement of tariffs on its exports to COMESA countries).

Removing all tariffs that Ethiopian exports are facing in COMESA countries imply USD 10.7 million new exports for Ethiopia. The gains are concentrated on two sectors. The vegetable plaiting materials and vegetable products sector (HS 14) and the sugars and sugar confectionery sector (HS 17) are going to gain respectively about USD 7.5 million and USD 2.2 million. Sectors like coffee, tea mate and spices (HS 09) and raw hides and skins and leather (HS 41) will also register a significant rise in their exports (respectively USD 0.27 and 0.12 million). These Ethiopian exports gains (USD 10.7 million) are lower than the new imports originating from COMESA countries (USD 27 million) and far lower than imports coming from the EU (USD 149 million). These results highlight the fact that Ethiopia could draw some potential benefits from entering the COMESA's FTA. Yet, these benefits would be realized through a strong improvement of Ethiopian supply capacities during the EPA transitional period in order for Ethiopia to be able to benefit fully from both trade agreements. Deepening regional integration combined with financial support from the EU can be a good opportunity for the Ethiopian economy to improve its exports' capacity and diversity.

Table 22: Ethiopian exports change in COMESA (\$'000)

HS Code	Description	Exports Change
HS.01	Live animals	2.268
HS.02	Meat and edible meat offal	3.869
HS.03	Fish, crustaceans, molluscs, aquatic invertebrates nes	0.457
HS.04	Dairy products, eggs, honey, edible animal product nes	4.869
HS.05	Products of animal origin, nes	0.005
HS.07	Edible vegetables and certain roots and tubers	67.145
HS.08	Edible fruit, nuts, peel of citrus fruit, melons	3.949
HS.09	Coffee, tea, mate and spices	267.518
HS.10	Cereals	73.184
HS.11	Milling products, malt, starches, inulin, wheat gluten	58.5
HS.12	Oil seed, oleagic fruits, grain, seed, fruit, etc. nes	79.213
HS.13	Lac, gums, resins, vegetable saps and extracts nes	29.451
HS.14	Vegetable plaiting materials, vegetable products nes	29,451
HS.17	Sugars and sugar confectionery	2181.693
HS.19	Cereal, flour, starch, milk preparations and products	2.31
HS.20	Vegetable, fruit, nut, etc food preparations	0.245
HS.21	Miscellaneous edible preparations	0.071
HS.22	Beverages, spirits and vinegar	22.733
HS.23	Residues, wastes of food industry, animal fodder	11.558
HS.25	Salt, sulphur earth, stone, plaster, lime and cement	21.809
HS.27	Mineral fuels, oils, distillation products, etc	2.011
HS.30	Pharmaceutical products	0.024
HS.32	Tanning, dyeing extracts, tannins, derivs, pigments etc	0.717
HS.33	Essential oils, perfumes, cosmetics, toileteries	6.15
HS.34	Soaps, lubricants, eaxes, candles, modelling pastes	0.327
HS.37	Photographic or cinematographic goods	0.261
HS.38	Miscellaneous chemical products	0.056
HS.39	Plastics and articles thereof	7.951
HS.40	Rubber and articles thereof	2.53
HS.41	Raw hides and skins (other than furskins and leather)	116.144
HS.42	Articles of leather, animal gut, harness, travel goods	4.507
HS.44	Wood and articles of wood, wood charcoal	0.681

*(Table 22 Continued)*

HS.46	Manufactures of plaiting material, basketwork, etc.	0.268
HS.48	Paper & paperboard, articles of pulp, paper and board	3.519
HS.49	Printed books, newspapers, pictures etc	0.108
HS.52	Cotton	53.694
HS.57	Carpets and other textile floor coverings	0.257
HS.58	Special woven or tufted fabric, lace, tapestry etc.	0.015
HS.61	Articles of apparel, accessories, knit or crochet	10.151
HS.62	Articles of apparel, accessories, not knit or crochet	17.041
HS.63	Other made textile articles, sets, worn clothing etc.	9.23
HS.64	Footwear, gaiters and the like, parts thereof	0.04
HS.65	Headgear and parts thereof	0.04
HS.68	Stone, plaster, cement, asbestos, mica, etc articles	4.293
HS.69	Ceramic products	16.155
HS.70	Glass and glassware	0.034
HS.73	Articles of iron or steel	1.646
HS.75	Nickel and articles thereof	0.093
HS.76	Aluminium and articles thereof	0.295
HS.82	Tools, implements, cutlery, etc of base metal	1.998
HS.83	Miscellaneous articles of base metal	0.015
HS.84	Nuclear reactors, boilers, machinery, etc	53.575
HS.85	Electrical, electronic equipment	24.043
HS.86	Railway, tramway locomotives, rolling stock, equipment	0.448
HS.87	Vehicles other than railway, tramway	21.005
HS.88	Aircraft, spacecraft, and parts thereof	5.963
HS.90	Optical, photo, technical, medical, etc apparatus	1.66
HS.91	Clocks and watches and parts thereof	0.009
HS.92	Musical instruments, parts and accessories	7.117
HS.94	Furniture, lighting, signs, prefabricated buildings	17.61
HS.95	Toys, games, sports requisites	0.051
HS.96	Miscellaneous manufactured articles	0.044
HS.97	Commodities not elsewhere specified	0.386
Total		10707.936

Source: WITS/SMART Model.



### 3.5 Sensitive products

#### A. Which kind of sensitivity

The WTO agreements contain provisions that allow departing from the MFN clause in the case of regional trade agreements. Article XXIV of the 1947-GATT, completed by an understanding attached to the Marrakech Agreement of 1994-GATT defines the modalities under which WTO members may not respect the MFN clause in trade in goods, when engaging in a free trade agreement process. Article V (para. 3.a) of the General Agreement on Trade in Services (GATS) provides with similar exemptions with regard to trade in services. Both article XXIV of GATT and article V of GATS stipulate that more preferential treatment may be granted among some members, without automatic extension to the entire WTO membership as is normally required under the MFN clause. The justification behind this derogation to the MFN principle is that, under certain conditions, free trade agreements benefit not only their members, but also the global economy as a whole, through trade creation which results in increased overall welfare. Free trade agreements such as the EPAs clearly could fall under that category, provided they are of a reciprocal nature (i.e. both parties offer each other symmetrical preferential treatment).

However, ACP countries might want to explore possibilities of maintaining a certain degree of asymmetry in their future agreement with the EU. Article XXIV leaves room for ambiguity with regard to this point. In particular, article 8(b) stipulates that “duties and other restrictive regulations [...] are [to] be eliminated on substantially all the trade” between the members of a preferential agreements. The exact meaning of “substantially all the trade” is strongly debated. How much trade may not be liberalised is a crucial question, and could be important for African countries willing to maintain some protection on some of their trade with the EU in the context of an EPA. It is generally thought that at least 90 percent of the trade has to be liberalised under a free trade agreement, but there is no legal confirmation for that figure. The EU-South Africa free trade agreement, for example did interpret the Article XXIV in a manner allowing for some protection within the 90 percent limit, in a non-reciprocal manner. Under this free trade agreement, the EU agreed to extend liberalization on 95 percent of its trade with South Africa, while South Africa agreed to liberalise “only” 86 percent of its imports from the EU.

Article XXIV also maintains some ambiguity on the schedule to accomplish liberalization. Here the agreement mentions “a reasonable length of time” (Art. XXIV, par. 5c). Again, there is no legal or official interpretation of what a reasonable length of time might be, although it is conventionally thought to be ten years. For example, South Africa was offered 12 years to implement liberalization in its free trade agreement with the EU, more time than the EU is allowed to liberalise its imports from South Africa. Again, the ambiguity contained in Article XXIV has in this case been utilised to maintain a certain degree of asymmetry. The schedule of liberalization may be important for African countries implementing EPAs, as they determine how much time they have to proceed to internal industrial adjustments before liberalization.

Importantly for African countries (and also for other developing countries), the Doha Declaration launched an effort to clarify the understanding of Article XXIV and the role of Special and Differential treatment in regional trade agreements. These points of negotiations under the WTO will be of crucial importance in determining the future shape of EPAs, and the degree of flexibility African countries might enjoy under them.

According to these elements, Ethiopia and ESA countries are allowed to define sensitive products that can be excluded from the liberalization process. There are different ways to define the “sensitivity”. One could argue that countries like Ethiopia are very sensitive to their tariffs revenues shortfall. In this case, it is obvious that the products that are expected to lead to the largest losses in tariff revenues have to be excluded from the liberalization process. According to the scenarios of this study, these groups of products are the one, which lead to the more significant losses:

- HS.87 Vehicles o/t railw/tramw roll-stock, pts & access;
- HS.84 Nuclear reactors, boilers, mchy & mech appliance;
- HS.85 Electrical mchy equip parts thereof; sound record;
- HS.94 Furniture; bedding, mattress, matt support, cushi;
- HS.90 Optical, photo, cine, meas, checking, precision.

However, these groups are defined at the level HS2. It is important to define the concerned products at a more detailed HS6 level for two reasons. The tariff revenues are not equally distributed in a group at the HS2 level. Some products are intermediary consumptions for the Ethiopian companies. So it is important to distinguish between these products in the exclusion process. Another reason is that during the negotiation process, the EU is expecting a list of products at the detailed HS6 level. So, it is also important to define these products at the earlier stage of the negotiations, to be able to better benefit from the negotiations process.

According to the WITS/Smart simulations, the sensitive products at the HS6 level for Ethiopia are the following in the decreasing order:

- Seats (other than those of heading 94.02), whether or not convertible into beds, and parts thereof. (HS Code: 940161)
- Motor vehicles for the transport of ten or more persons, including the driver (HS Code: 870210)
- Motor cars and other motor vehicles principally designed for the transport of persons (other than those of heading 87.02), including station wagons and racing cars. Of a cylinder capacity exceeding 1,500 cc but not exceeding 3,000 cc (HS Code: 870323)
- Motor cars and other motor vehicles principally designed for the transport of persons (other than those of heading 87.02), including station wagons and racing cars. Of a cylinder capacity exceeding 1,000 cc but not exceeding 1,500 cc (HS Code: 870322)

- Motor cars and other motor vehicles principally designed for the transport of persons (other than those of heading 87.02), including station wagons and racing cars. Of a cylinder capacity exceeding 1,500 cc but not exceeding 3,000 cc (HS Code: 870332)
- Motor vehicles for the transport of goods, exceeding 5 tonnes but not exceeding 20 tonnes (HS Code: 870422)
- Magnetic tape recorders and other sound recording apparatus, whether or not incorporating a sound reproducing device. (HS Code: 852039)
- Motor vehicles for the transport of goods.g.v.w. not exceeding 5 tonnes (HS Code: 870421)
- Parts and accessories of the motor vehicles of headings 87.01 to 87.05.Other (HS Code: 870899)

The second way to define the sensitivity is to link the negotiations to the Ethiopian development strategy. Excluding some products from the liberalization can protect sectors that have a potential to expand according to the Ethiopian comparative advantages. The tools used in this study are not able to define these kinds of products. This definition should be based on specific expert studies at the sector level. Generally, it appears that agro-processing, cotton, textiles, leather and leather products have a huge potential for growth within the Ethiopian economy. A further step is to identify, at a more detailed level, which products need dismantlement in their intermediary consumption, to improve their competitiveness, and which ones need protection. In the COMESA negotiation process, Ethiopia has proposed a list of products that it considers being of economic importance based on their contributions to revenue, GDP and employment. The list proposed covers the following products which are all related to agriculture: Coffee, Livestock, Leather, Textiles, Sugar, Bottled water, Wheat flour and Food crops including cereals, pulses and oil seeds. Therefore, there is a clear need to consider this list at a more detailed level on the one hand, and to conduct other studies on the potential of the Ethiopian manufacturing sectors on the other hand.

## **B. Simulations with sensitive products**

### ***1) Fiscal sensitivity***

The first scenario (full liberalisation with the EU) allows us to define a list of products that implies the bigger revenue losses. According to this list and to the article XXIV, we can assess the impact of an EPA on the Ethiopian economy excluding these products. However, one should define the number of excluded products. Article XXIV stipulates that “duties and other restrictive regulations [...] are [to] be eliminated on substantially all the trade” between the members of a preferential agreements. The EU considers that a substantial part can be interpreted as 90% of the trade. On this base we made two simulations excluding a number of HS6 product that represents respectively 10% and 20% of the Ethiopian Imports from the EU.

Table 23: Welfare impact with and without sensitive products

Welfare changes after EPAs (\$'000)	
Variation of welfare with full liberalisation	19029.48
Variation of welfare with 10% sensitive products	11812.02
Variation of welfare with 20% sensitive products	10453.91

Source: WITS/SMART Model, details in annexes.

Compared to the full liberalisation with the EU scenario, excluding 10% of the imports, according to the most fiscal sensitive products criteria, have a strong impact on the Welfare, which is reduced by 38% (table 23: from 19 to USD 11.8 million). This huge reduction is due to the fact that these products are final ones and affect directly the consumer, who is going to pay a consequent higher price than the one in the full liberalisation scenario.

Exclusion of 20% of the imports doesn't change a lot the effect on the consumer welfare, which is reduced only by USD 1.36 million, compared to the 10% scenario. This is not the case in term of revenue impact (table 24). The 10% exclusion reduces the revenue losses by 22.3% (USD 12.3 million), while the 20% reduces the losses by near 40% (USD 21.8 million).

Table 24: Revenue impact with and without sensitive products

Variation of tariff revenues (\$'000)	
tariff revenues variation in full liberalization	-55126.4
Tariff revenues variation with 10% sensitive products	-42851.4
Tariff revenues variation with 20% sensitive products	-33304.2

Source: WITS/SMART Model, details in annexes.

The results in table 25 shows that excluding from liberalization 10% of the initial trade has a more than proportional effect on the final trade. The new imports from the EU are then reduced by near 27% in the 10% scenario and by more than 41% in the 20% one. This is a good illustration of the power of high tariffs in trade inhibition.

Table 25: New imports from the EU with and without sensitive products

Import variation from the EU (\$'000)	
Variation of imports with full liberalisation	151830.1
Variation of imports with 10% sensitive products	111024.3
Variation of imports with 20% sensitive products	89031.5

Source: WITS/SMART Model, details in annexes.

Trade diversion that suffers COMESA countries seems to be very sensitive to product exclusion. Compared to the full liberalization, in the 10% scenario, COMESA trade diversion is reduced by near 30 %, while the diversion for the rest of Africa is reduced only by less than 8%. The 20% scenario gives the same report. That means that excluding these products in the EPA, but including them in the COMESA integration process will promote regional integration (table 30 shows the same kind of results).

Table 26: Trade diversion with and without sensitive products

Trade diversion (\$'000)	COMESA	Res of Africa	Rest of the World
Variation of imports in full liberalisation	-3611	-1029	-26512
Variation of imports with 10% sensitive products	-2550	-954	-20136
Variation of imports with 20% sensitive products	-1861	-849	-16818

Source: WITS/SMART Model, details in annexes.

## 2) Strategic sensitivity

Above, we argued that the tools used in this study are not able to define products within sectors that have a potential to expand according to the Ethiopian comparative advantages. However, we can conduct some liberalisation simulations where we exclude the goods according to their place in the production process.

Three simulations were made:

- Liberalisation with the EU only for the raw goods;
- Liberalisation with the EU only for the raw and capital goods;
- Liberalisation with the EU only for the raw, capital and intermediary goods.

We compared the results with the first scenario of full liberalisation with the EU. The table below indicate that the full liberalisation provide the biggest amount in term of Welfare. This is not surprising as it's the only scenario that includes final goods, knowing that the welfare is related to the consumption. Opening

only on raw material don't improve really the welfare. Including capital goods have a strong effect, but smaller than the final good ones, on the rise of the welfare (from 0.1 to 5.5 millions USD).

Table 27: Welfare impact in different liberalisation schemes

Welfare changes after EPAs (\$'000)	
Variation of welfare with full liberalisation	19029.481
Variation of welfare in raw and capital goods liberalisation	5471.032
Variation of welfare in raw, capital and intermediary goods liberalisation	6655.741

Source: WITS/SMART Model, details in annexes.

In terms of revenue impact, table 28 shows that the principal impact on revenue is due to capital goods, with USD 23.5 millions and final goods (more than 22 million dollars). With USD 2 millions, liberalisation on raw material has a small effect on revenue. The impact of intermediary goods liberalisation has also a relative small impact (USD 7.3 million).

Table 28: Revenue impact in different liberalisation schemes

Variation of tariff revenues (\$'000)	
Tariff revenues variation in full liberalisation	-55126.359
Tariff revenues variation in raw material liberalisation	-2097.221
Tariff revenues variation in raw material and capital goods liberalisation	-25612.334
Tariff revenues variation in raw material, capital and intermediary goods liberalisation	-32951.071

Source: WITS/SMART Model, details in annexes.

These results advocate for a strong liberalisation on raw material and intermediary goods, according to the fact that this kind of liberalisation improves the Ethiopian economy competitiveness. In the case of capital goods, one should differentiate the liberalisation at the product level according to the Ethiopian development strategy.

Table 29: New imports from the EU according to different liberalisation schemes

Import variation from the EU (\$'000)	
Variation of imports in full liberalisation	151830.122
Variation of imports in raw material liberalisation	2375.186
Variation of imports in raw and capital goods liberalisation	61936.733
Variation of imports in raw, capital and intermediary goods liberalisation	77360.258
Tariff revenues variation in raw material, capital and intermediary goods liberalisation	-32951.071

Source: WITS/SMART Model, details in annexes.

Table 29 shows that the new imports from the EU are concentrated on capital and final goods. These results confirm the previous ones on the fact that the Ethiopian position on the products to exclude from the liberalization should be based on a deep analysis on these two groups. Obviously, definition of sensitive products should also consider the two other groups (raw material and intermediary products), but the priorities have to be given to final and capital goods.

We saw in the previous scenarios that the EPA's can undermine the Regional Integration process within Africa. In the case of COMESA, more than half of trade diversion is due to final goods (55%), which is not the case for the rest of Africa (43%), and the rest of the world (46%). That means that if Ethiopia wants to improve Regional Integration at the same time at the EPA, the excluded final products in this last negotiation should be included in the COMESA integration process. This is also valid for capital and intermediary products, which are also concerned by trade diversion.

Table 30: Trade diversion according to different liberalisation schemes

Trade diversion (\$'000)	COMESA	Rest of Africa	Rest of the World
Variation of imports in full liberalisation	-3611	-1029	-26512
Variation of imports in raw material liberalisation	-25	-16	-1158
Variation of imports in raw and capital goods liberalisation	-1042	-176	-8245
Variation of imports in raw, capital and intermediary goods liberalisation	-1638	-591	-14401

Source: WITS/SMART Model, details in annexes.

## IV. Adjustment costs

Another consistent result from the simulations is the potential adjustment costs that Ethiopia will have to bear as a result of revenue shortfalls. Given the prominence of the EU imports into this country, the reliance of Ethiopia on tariff revenues, the tariff dismantlement results in all cases in significant revenue shortfalls. The major challenge that these revenue shortfalls will pose is the adjustment costs associated with tax policy and administration reforms. The EPAs, if no appropriate measures are put in place to forestall the macroeconomic imbalances that are likely to result from the falling revenues, will have the possibility of undermining developmental objectives of Ethiopia and African countries in general.

The first adjustment cost is the shortfall in revenues. This study showed that the first scenario could reduce the tariffs revenues by \$55 million. Furthermore, the fourth scenario that implement deepening regional integration, additional to the FTA with EU, which is one of the EPAs principle implies a fiscal shock estimated at \$65.7 million. One could argue that this amount is the maximum revenues shortfall that can occur if Ethiopia removes all the tariffs in one shot. The reality of the negotiations implies that some products are going to be excluded from the removal, which will be progressive. However, as noted above, fiscal reforms are long and complicated and have lots of dimensions. The nature of these reforms is such that they are not only financial, but also involve human resources. Administration of income taxes and consumption taxes such as the VAT are more human capital demanding than the administration of import duties. Such kind of reform is implemented on several years. So one could advocate for a huge reform program that needs financial support from the EU, and which can help to absorb this fiscal shock.

Macroeconomic stability is a pre-condition for promoting economic development by trade liberalization. Complementary measures are also required to ensure that moving from a restrictive to an open-trade regime does not lead to a fiscal shock and macroeconomic instability. Therefore, unavoidable short- and medium-term losses in government revenue need to be cushioned. The ability of developing countries to collect domestic taxes for public expenditure programmes will depend not only on the enactment of appropriate tax legislation but also, more important, on the enforcement of compliance (Todaro and Smith 2003). Tax evasion and avoidance are serious problems in collecting taxes. Given these difficulties, the costs of tax administration have to be taken into account. Tax and fiscal reforms are particular areas where the EU could provide support for the effectiveness of structural adjustment in Ethiopia. This would be in accordance with the Cotonou Agreement, which earmarks transitional support (budgetary support, technical assistance) for this purpose. It is agreed that special consideration will be given to countries that face budgetary adjustments due to regional integration and EPAs.

The second adjustment cost is the fact that Ethiopia and its domestic companies should suffer by this huge increase of imports that is going to destabilize the balance of trade. So it is important to manage



the liberalization process more properly, by designing a suitable timing and sequencing and identifying and implementing complementary measures. A “gradualist” approach is needed because it takes time to implement the complementary measures that are required to ease the inter-sectoral adjustment process and the reduction or elimination of direct and indirect barriers to trade. Some complementary measures need to be taken well in advance while others could accompany trade liberalization, depending on the economic, political, social and institutional capacity to absorb adjustment costs. Ethiopian Government should identify the sectors that are going to suffer the most from this agreement. Indeed, it could be very useful to strengthen the production capacities of these vulnerable sectors in such a way that they could be modernized and therefore contribute fully to the industrial diversification. Probably, there is also a need to establish social safety nets that compensate displaced workers and provide the poor with a minimal standard of living below which they should not fall.

The macroeconomic instability created by a trade balance destabilization can be tackled at the balance of payment level. New investment flows from the EU can compensate the huge increase of imports from the EU. The orientation of these investment flows to the sectors that need to improve their capacity can render the EPA mutually profitable. Last but not least, the EU should assist Ethiopia for a longer period of time in order to provide the latter with an incentive to ensure that Ethiopia as well as other ACP countries benefit as much as possible from the EPAs. The EU support could also cover additional trade-related measures. For instance, there is a need to modernize customs administration in Ethiopia. It is necessary to ensure smooth cross-border transport of goods and to reduce/eliminate delays and unnecessary additional transport costs. In terms of infrastructure, the NEPAD investment projects identified the necessary needs to facilitating regional trade. Another starting point for the EU support could be the capacity building dedicated to allowing Ethiopian exporters to be able to fulfil the conditions required to access European markets. This support can be useful at different levels. At the public level there is a need to strengthen institutions like the Ethiopian Investment Authority, the Quality and Standards Authority of Ethiopia or several sartorial authorities that are major players in exports capacity buildings. There is a particular need for activities related to sanitary and phytosanitary measures. At the private sector level, enhancing competitiveness at different levels is a requirement to benefit from the EPA. Funds dedicated to increase productivity, quality, and response time delivery are necessary.

## V. Conclusion

Ethiopia can expect limited gains in consumer welfare from the Economic Partnership Agreement East and Southern African (ESA) countries are negotiating with the EU. These gains are not significant and not proportional to the cost of the agreement. This cost will be particularly heavy for the public resources of the Ethiopian government, as public revenues losses would amount to a maximum of 4 percent of the 2002/2003 revenues level. In terms of external accounts, the impact of the EPA could also be significant, as imports would grow by \$120 million, which represents 7.5 percent of the 2002 imports volume. Above all, EPA is inimical for the long-term strategy of Ethiopia. Instead of leading the country to deepen regional integration and diversify its output, EPA will revitalize the trading partnership with Europe, as well as the traditional agricultural specialization of the country.

The consistent outcome from the scenarios is that the EU stands to gain significantly in terms of expanded trade into Ethiopia. While part of this trade expansion will result from trade creation, which is welfare improving, significant proportions of the trade gain will also be due to trade diversion from the rest of the world and from within the ESA EPA grouping that Ethiopia is part of. As a result, while the reciprocity principle appears to be trade expanding, it will pose serious implications for deepened regional integration in the Eastern and Southern Africa region. Indeed, unless there are clear mitigating measures, the EPA could seriously undermine the gains that have been achieved so far in the integration process of the region. Another consistent result from the simulations, are the potential adjustment costs that Ethiopia will have to bear as a result of revenue shortfalls. Given the prominence of the EU imports into the country, the tariff dismantlement in each of the scenarios result in significant revenue shortfalls. The major challenge that these revenue shortfalls will pose is the adjustment costs associated with tax policy and administration reforms. The EPAs, if no appropriate measures are put in place to forestall the macroeconomic imbalances that are likely to result from the falling revenues, will have the possibility of undermining developmental objectives of Ethiopia.

The fourth scenario of the study shows that Ethiopia will increase its welfare if it combines the EPA with a free trade area with COMESA countries. Deepening regional integration can also improve the Ethiopian supply capacities. However, according to the fiscal shock that an EPA can imply, it is better to “postpone” the EU fiscal shock, after the COMESA one (which is smaller), in order to reduce the global amplitude. Having a long EPA implementation period is then a crucial issue. Another important conclusion from the four scenarios is that the consequences of the EPA for the Ethiopian economy will depend on the product lines concerned by the agreement. In value terms, the more industrial products will be concerned, the stronger the trade diversion will take place within COMESA and the rest of Africa, hampering regional integration. These outcomes of the EPAs on Ethiopia are consistent with the emerging evidence from other studies on the region. This evidence can be summarised as follows: the

EPAs will exacerbate strain on fiscal systems in Africa; Undiversified economic structures in Africa will face unprecedented challenges; consumers in African countries will be major beneficiaries from the EPAs; the non-EU countries will face reduced market share in Africa; and regional integration efforts in Africa are likely to be hampered through trade diversion from African countries.

The overarching conclusion from all the emerging evidence which applies to Ethiopia is that sequencing of policy reforms that Africa will need to undertake is critical to the success of the EPAs. The EPAs should focus more on deepening intra-African trade. Hence, Ethiopia should focus on joining the COMESA FTA and on consolidating anticipated gains from the region before the opening up to the EU. This should be given sufficient lead-time to allow African countries to build the requisite competitiveness. This would have to be accompanied with significant developmental programmes to complement the larger markets with increased supply and diversified capacities. Eventually, any tariff dismantlement by African countries will need to be implemented in phases hand in hand with unrestricted market access for the African exports into the EU market. Clearly, the 10-12 years period interpreted from Article XXIV of GATT is only sufficient for the deepening of the intra-African trade . The EPAs should look beyond the 12 years as the possible dates for introducing reciprocity. Before then, unrestricted market access and deeper African integration will have provided sufficient room for supply capacities and exports diversity to be built in the continent.

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