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Peace Corps photo by Brandon Lundy

Trade Among Unequal Partners

Changing EU Trade Arrangements With Developing Countries

The European Union (EU) has been a major player in the General Agreement on Tariffs and Trade (GATT) since its inception in 1947 and in World Trade Organization (WTO) agreements since 1995, when the WTO began administering international trading rules. The foremost WTO principle is most-favored-nation (MFN) treatment, requiring WTO members to accord all members the best trading conditions provided to any particular country. Implicitly, the MFN principle precludes special trading arrangements.

WTO rules provide exceptions to the MFN principle, however. Far more than other WTO members, the EU has used these exceptions to justify preferential trading arrangements. The EU's many preferential arrangements form a mosaic of tariffs, quotas, and other restrictions on EU agricultural imports (*AO* December 2001).

Some EU preferential trading arrangements with developing countries were challenged under GATT procedures, and again more recently in the WTO, as

discriminatory and not in compliance with international trade rules. The challenges focused on EU import regimes that favored EU distributors over other distributors and former colonies over other countries.

Since 1996, EU actions and proposals to make its trading arrangements compatible with WTO rules have centered on renegotiation of arrangements with some developing countries to establish free trade areas. The WTO compatibility of EU proposals and of numerous elements of current EU preferential arrangements remains controversial and untested in the WTO, however.

The proposed free trade areas could have important implications for global trade. Some developing countries could face difficult new trade competition and economic challenges, without clear new advantages. The EU, on the other hand, will gain strong advantages for its agricultural and other exports to some developing countries at the expense of exports from the U.S. and other countries.

WTO Exceptions to the MFN Requirement

The GATT and WTO agreements have recognized a need to improve developing countries' access to world markets. Since 1979, the "Enabling Clause" has provided a permanent exception from MFN obligations so that developed countries "may accord differential and more favorable treatment to developing countries" through a "system of generalized, nonreciprocal, and nondiscriminatory preferences" (usually referred to as a Generalized System of Preferences, or GSP).

Under GSP provisions, developed countries do not expect reciprocity for commitments made by them in trade negotiations to reduce or remove tariffs and other barriers to the trade of developing countries. Developing countries are not required to make concessions that are inconsistent with their development, financial, and trade needs. These provisions for nonreciprocal concessions acknowledge that developing countries cannot necessarily compete economically with developed countries.

The Enabling Clause also provides that countries identified as Least Developed Countries (LDC) by the United Nations may be granted even more favorable treatment. Additional concessions for the LDCs allow for differentiation of trading preferences based on economic capabilities and needs.

WTO rules provide another, very different, exception to MFN obligations. WTO members may establish free trade areas (FTAs) within which the duties and other restrictive regulations of commerce (except where expressly permitted within WTO rules) are eliminated on substantially all trade between the member countries. Unlike nonreciprocal arrangements, FTAs expose all partners to economic competition with all other partners at zero duties on substantially all traded goods.

In addition to the FTA and GSP exceptions, special waivers of MFN or other WTO obligations can be granted with approval of three-fourths of WTO members.

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EU Trade Arrangements & WTO Compatibility

The EU (previously as the European Community) has provided a GSP to most developing countries since 1971. Since the 1970s, the EU also has provided special nonreciprocal tariff reductions for former African, Caribbean, and Pacific (ACP) colonies and for Mediterranean countries. For agricultural products, many of these concessions have been limited by quotas. Historically, most EU preferential arrangements with developing countries have been nonreciprocal, providing no preferences to EU exports. The EU's preferential trade agreements have provided relatively greater advantages to some developing countries, effectively disadvantaging others. Least favored are the GSP countries that are neither LDCs, ACP, or Mediterranean countries.

Challenges to EU preferential trading arrangements have arisen from unresolved ambiguities in WTO provisions. Most publicized has been a challenge to the EU banana import regime. The EU's banana regime clearly was GATT/WTO-incompatible long before resolution of the case in 2001. Several countries had successfully challenged the banana quotas in 1992, but the EU prevented adoption of the panel rulings by blocking the consensus required under GATT dispute resolution rules. The U.S. filed a case against the regime in 1997 under the new WTO dispute settlement procedures. The WTO panel found the regime to be discriminatory. Because of the binding nature of WTO dispute settlement and the procedures providing for automatic adoption of WTO findings, no longer requiring consensus, the EU could not ignore the WTO findings.

Binding WTO dispute resolution procedures have greatly improved prospects for less-favored developing countries to successfully challenge EU trading arrangements. These countries presented considerable resistance in 2001 to a waiver for newly adopted ACP arrangements, which included the revised EU banana quotas. Since 1994, Brazil, India, Venezuela, and Thailand have filed challenges to the EU's GSP.

Initial Terms

ACP	African, Caribbean, and Pacific: former colonies of Britain and France.
CAP	Common Agricultural Policy: the policy that governs agriculture within the European Union.
EBA	Everything But Arms: a policy providing for duty- and quota-free imports from the least developed countries.
EU	European Union: the economic and free trade grouping of most western European countries, now enlarging to include some eastern European and Mediterranean countries.
FTA	Free Trade Area: as provided for by Article XXIV of the GATT.
GATT	General Agreement on Tariffs and Trade: the original rules governing international trade, augmented by various WTO agreements since 1994.
GSP	Generalized System of Preferences: a GATT exception to MFN requirements allowing developed countries to provide preferential arrangements for developing countries.
LDC	Least Developed Countries: the poorest countries as designated by the United Nations.
MFN	Most-favored-nation treatment: the fundamental principle of the WTO requiring all countries to provide the same trading conditions to all WTO members.
WTO	World Trade Organization: since 1994, the organization supervising the GATT and WTO agreements governing international trade.

Generalized System of Preferences. The EU's GSP provides reduced tariffs without quotas on selected products to most developing countries. However, only small or no tariff reductions are granted on most agricultural products supported by the EU's Common Agricultural Policy (CAP). Additional tariff reductions are granted to countries observing environmental or labor standards and for participation in drug control programs. Since March 2001, under its *"Everything But Arms"* (EBA) policy, the EU has provided duty- and quota-free access to its markets for the agricultural products of 42 LDCs. Quotas will manage transition to duty-free and quota-free imports of sugar, bananas, and rice until 2008. The EU's current GSP program expires in 2004, and will be reconsidered at that time.

Some countries have been "graduated"—i.e., GSP preferences have been withdrawn because a country became relatively wealthy, or became a dominant supplier of EU imports of a particular commodity.

Nine countries, including Brazil, Argentina, Malaysia, and Thailand, have lost preferences on specific agricultural commodities. South Korea and Taiwan have lost all preferences.

The EU has not acknowledged any WTO incompatibilities regarding its GSP, even though faced with challenges. The challenges focus on the graduation (withdrawal of preferences) for some countries, and on tariff concessions related to environmental, labor, and drug programs. Challenges see these provisions as inconsistent with the Enabling Clause's provision for generalized and nondiscriminatory preferences for all developing countries. Provisions of the EBA policy have not been controversial and have not been challenged in the WTO.

Nonreciprocal ACP and Mediterranean arrangements. In addition to the GSP, the EU has granted special nonreciprocal trade preferences to 76 former ACP colonies and to Mediterranean countries since the

1970s. Unlike the GSP, which is quota-free but generally with somewhat higher tariffs, tariff-rate quotas limit some of the most valuable ACP and Mediterranean tariff preferences. Particularly important are ACP protocols for EU imports of 52,000 tons of beef from 6 ACP countries and 1.2 million tons of sugar from 13 other ACP countries. The Mediterranean countries have had valuable import quotas for fruits and vegetables.

The EU banana import regime favored EU banana distributors over distributors of other countries, and former ACP colonies over other developing countries. The WTO dispute panel found the banana import quotas for former colonies to be discriminatory and inconsistent with WTO rules. Following the WTO panel finding, the EU requested a waiver and received approval by the necessary three-fourths of WTO members to operate the ACP arrangements, including a revised banana regime, for an interim period while implementing a tariff-only system for banana imports and renegotiating EU trading arrangements with ACP countries.

Of WTO disputes that involve preferential trading arrangements, only the EU banana case has so far been resolved through WTO dispute resolution. The findings in that case are numerous and complex, limiting clear application to other situations. Consequently, many issues relating to WTO requirements for preferential trading arrangements remain unresolved. Positions taken by the EU and others relating to preferential arrangements await clarification through WTO dispute panels or multilateral negotiations. At this point, none of the EU's current FTA agreements, or those of other countries, have been verified by WTO review processes as fully consistent with WTO requirements.

Without clarity on important issues relating to preferential trade arrangements, the EU is proceeding based on its own view of WTO requirements. EU positions are implicit in its proposals, background papers, and the provisions of EU trading agreements already negotiated. In nonreciprocal arrangements, the EU appears to believe that preferences to a selected group of developing countries require a waiver of MFN obligations.

WTO rules also require that administration of quantitative restrictions be nondiscriminatory—"no prohibition or restriction shall be applied by any contracting party on the importation of any product of the territory of any other contracting party...unless the importation of the like product of all third countries...is similarly prohibited or restricted." EU proposals imply that the provision of tariff-rate quotas for a selected group of developing countries within nonreciprocal arrangements requires a waiver of that WTO requirement.

The overarching problem for the EU is that current WTO rules provide limited unambiguous scope for differentiation of trading preferences among developing countries.

Free trade area agreements. The EU itself is an FTA, and the EU has FTA agreements with Mexico, South Africa, and various non-EU European and Mediterranean countries. FTAs have been controversial. In review of more than 120 FTA agreements, GATT and WTO working parties on regional trade agreements have almost never agreed unanimously that GATT or WTO criteria were fully met. Lack of binding dispute resolution before 1994 seriously limited effective challenges, however.

EU FTA agreements include tariff-rate quotas for sensitive agricultural products that compete with EU products, even though WTO provisions for FTAs call for free trade and do not provide for quota restrictions. Whether tariff-rate quotas within FTAs must conform to WTO requirements for nondiscriminatory administration of quantitative restrictions is a key unresolved issue. Current EU FTA agreements and EU proposals imply that the EU considers that tariff-rate quotas need not be nondiscriminatory so long as "substantially all the trade" is duty- and quota-free. The EU strategy is that current tariff-rate quotas for sensitive agricultural products in nonreciprocal relationships can be maintained without waivers within FTA agreements. This

proposition has not been tested within the WTO, however.

While the WTO requires that "substantially all the trade" within an FTA be liberalized, no precise interpretation of that phrase has yet been established. The EU has interpreted the requirement to mean substantially all historical trade. The problem with relying on historical trade is that it effectively allows continuation of significant historical trade barriers. Historical trade has excluded the EU's most sensitive agricultural products. EU FTA agreements protect sensitive agricultural products by excluding them from liberalization or by restricting imports through tariff-rate quotas. The EU-Mexico agreement, for example, provides for total liberalization of 95 percent of historical EU imports. For agriculture, however, only 62 percent of historical trade will be fully liberalized, and historical trade already excluded sensitive products. In the EU agreements with Mexico and South Africa, those countries also excluded some of their imports from liberalization.

Complying with WTO Rules

The overarching problem for the EU is that current WTO rules provide limited unambiguous scope for differentiation of trading preferences among developing countries. For example, should small or poor countries like St. Kitts or Senegal, which are not LDCs, be provided better trading preferences than larger and more economically powerful developing countries such as Brazil or China?

The WTO framework clearly provides for only four classes of differentiation between trading partners: 1) MFN treatment, 2) bilateral reciprocal free trade, 3) nonreciprocal and nondiscriminatory preferences for developing countries, and 4) special nonreciprocal and nondiscriminatory preferences for the LDCs. Further differentiation among non-LDC developing countries remains controversial. To maintain historical trade preferences for some developing countries by opting for reciprocal FTA arrangements also provides large advantages for EU exports, especially in agriculture.

EU arrangements effectively have differentiated among non-LDC developing

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countries. GSP "graduation" (withdrawal of preferences) is based upon economic criteria related to trade performance or economic development. ACP preferences, however, are not based on economic criteria, but reflect the legacy of European colonial relationships. Nonreciprocal Mediterranean preferences also have had no economic basis, but reflect longstanding trade relationships and important political associations.

Having accepted that its trading arrangements with former colonies do not comply with WTO requirements, the EU has committed to negotiating FTA agreements with ACP and Mediterranean countries on the assumption that current ACP quotas are compatible with WTO requirements for FTAs. WTO provisions, however, do not necessarily support such an assumption. EU FTA agreements may be a fertile field for WTO contests.

Nonreciprocal Mediterranean arrangements shared most of the problems of ACP arrangements. Appropriate waivers could provide for current ACP or other arrangements, but the EU apparently assumes that politics would not allow for such waivers beyond the interim period to 2008 provided by the current waiver.

For some developing countries, solutions already are in place. For ACP countries that also are LDCs, the EBA policy provides the best preferences available and those preferences are uncontested. Solutions for the Mediterranean countries are also largely in place. Since 1997, FTA agreements with the Palestinian Liberation Organization, Tunisia, Israel, Morocco, Egypt, and Jordan have been implemented or negotiated to replace earlier nonreciprocal arrangements. Additional FTAs are envisioned to replace nonreciprocal arrangements with the remaining Mediterranean countries.

The EU proposes to negotiate FTA agreements by 2008 with several groupings of ACP countries. In the EU plan, regional integration would be enhanced, while the broader unity of ACP countries would be maintained. Agreements would provide development assistance to foster integration into the global economy. The agreements would include tariff-rate quotas

equivalent to current ACP provisions for sugar and beef.

Current EU provisions for the GSP expire in 2004. Proposals for a revised GSP have focused on bolstering preferences to provide a viable alternative for ACP countries that are unable or unwilling to enter into FTAs. Extension to all developing countries of preferences equivalent to current ACP preferences would reduce the value of ACP preferences. Some advocates of ACP countries would like to see WTO rules revised to allow for greater differentiation of preferences among developing countries. For LDC arrangements, no changes have been proposed.

Implications of EU's Proposed Free Trade Agreements

The implications of proposed FTA agreements depend on the EU policy context in which they would operate. To protect EU agriculture, the Common Agricultural Policy has carefully managed EU imports of agricultural products that compete domestically with those of EU producers. The CAP has ensured that import quantities are consistent with internal price objectives by applying tariffs high enough to raise the price of imports to CAP levels, by establishing minimum import price requirements, or by restricting import quantities to tariff-rate quota amounts.

The EU really cannot lose with the proposed FTA agreements. It is likely simply to continue current preferences, including quotas, in arrangements that it hopes will be WTO-compatible.

The EU is largely an open market for nonagricultural products, with an average MFN tariff of only 4.2 percent in 1999. However, for agricultural products, MFN tariffs average 30 percent and exceed 50 percent for grains, sugar, and frozen meats, and 87 percent for dairy products. The potential application of very high MFN tariffs enforces minimum import price requirements and ensures that imports do not exceed tariff-rate quota amounts, despite WTO elimination, in

principle, of all nontariff import restrictions. Most of the EU's agricultural tariff-rate quotas are provisions of preferential trading arrangements.

Since EU agricultural imports remain restricted by the CAP to amounts consistent with CAP internal price objectives, EU preferential trading agreements do not create trade. Principally, they determine the sources of imports. Throughout eight rounds of multilateral trade negotiations, the EU has maintained high MFN agricultural tariffs and retained effective control of its agricultural imports. The unconditional opening of EU agricultural markets to the LDCs under the EBA policy was possible because the limited export potential of those countries posed a limited threat to EU interests.

Current EU FTAs exclude sensitive agricultural products from liberalization. If proposed FTAs with ACP countries conform to historical practice, they are unlikely to expand EU agricultural imports. Without increased EU agricultural imports, the principal outcome of the revised agreements for developing countries may be some reallocation of historical EU imports among developing country partners.

The EU really cannot lose with the proposed FTA agreements. It is likely simply to continue current preferences, including quotas, in arrangements that it hopes will be WTO-compatible. While giving up little, the EU would gain preferred access to the markets of developing-country FTA partners. The U.S. and other exporters would lose share in these markets as the EU gains advantage.

The advantage for the EU could be quite strong for agricultural products. Developing countries maintain relatively high MFN agricultural tariffs, with average tariffs of 71 to 113 percent in Africa, the Caribbean, and South Asia and 39 percent in South America. MFN tariffs on cereals in the important North African markets average 84 percent. EU products priced well above world prices could be competitive as exports to FTA partners so long as the MFN tariff is as large as the gap between EU and world prices. The EU potentially would be able to export to FTA partners without subsidies, effective-

ly circumventing WTO restrictions on subsidized exports.

Even if the FTA agreements exclude some agricultural products from liberalization, important advantages for the EU could be obtained within quotas. Current FTAs include preferences for 800,000 tons of EU wheat annually to Mediterranean countries.

For developing countries, benefits from FTA agreements with the EU are uncertain. The strong advantage of LDCs in EU markets would be unaffected. ACP and Mediterranean countries entering into FTA agreements would largely maintain current preferences in EU markets, although proposed arrangements also would liberalize trade among regional neighbors.

Current proposals would diminish preferences only for non-LDC ACP countries that do not negotiate FTA agreements. ACP countries probably have had the best access to EU markets that is politically possible. They have had duty- and quota-free access to EU markets for all industrial goods and 80 percent of agricultural products, and they have been exempt from disciplines on textiles and clothing. Including duty-free agricultural imports within quotas, 99 percent of EU imports from non-LDC ACP countries enter duty-free. Of course, these imports do not include sensitive CAP products. Retention of current quotas for sugar and beef is key for ACP countries.

Loss of benefits by any ACP country would benefit all other countries, particularly those that are neither LDCs nor ACP countries. Those countries would be better off in the sense that they would be less disadvantaged. Moreover, successful challenges to the GSP could also benefit those countries that have graduated.

Proponents of reciprocal FTAs argue that economic integration will create trade, attract foreign investment, and lead to greater efficiency and improved competitiveness in developing countries. By expanding the effective home market,

regional economic integration would expand the range of viable economic activities, allowing for diversification of production and exports. They also argue that trade and other policy reforms would be locked in, leading to more stable and effective governance. A more stable economic and trade environment would stimulate higher levels of investment. FTAs also would benefit consumers by increasing real incomes through lowering import prices. Developmental assistance, which could be part of the FTA arrangement, would increase scientific and technical capacity and enhance infrastructures.

However, many developing countries are concerned about competition with the EU. Subsidized EU agricultural exports are particularly worrisome. Most developing countries are protected by agricultural and other tariffs that are much higher than those of the EU. Reduced tariff revenues could force drastic restructuring of government finance, and many fear worsening balance-of-payments problems. The most feared result of free trade would be partial deindustrialization and increased unemployment if imports from the EU and elsewhere displace domestic production.

EU proposals are for lengthy transition periods of up to 12 years, and transition would be asymmetrical, with the EU eliminating tariffs more quickly than developing countries. Liberalization of regional trade also would be more rapid than liberalization of trade with the EU, allowing competitiveness to be developed first through competition with other developing countries.

The impetus for revision of EU trading arrangements is WTO compatibility, but the options are limited. The conflict actually is among developing countries trying to obtain or maintain relative advantages over one another in access to EU markets. Reciprocal arrangements will not provide new advantages to ACP and Mediterranean countries, but rather maintain historical ones. The dangers of reciprocal trade agreements are central to the broader debate concerning the economic path of developing countries in the context of

Further Reading

USDA's Economic Research Service

"EU Preferential Trading Agreements: Heightened Competition for U.S.," *Agricultural Outlook*. December 2001. www.ers.usda.gov/publications/AgOutlook/dec2001/

European Union briefing room

www.ers.usda.gov/briefing/EuropeanUnion/

WTO briefing room

www.ers.usda.gov/briefing/WTO/

Commission of the European Union

Green Paper on relations between the European Union and the ACP countries on the eve of the 21st century—Challenges and options for a new partnership. Brussels: European Commission. 1996. www.europa.eu.int/comm/development/publicat/1-vert/lv_en.htm

Consequences for the ACP Countries of Applying the Generalized System of Preferences (GSP). Joint analysis by EU and ACP experts for Negotiating Group 3. Brussels. April 1999.

World Bank

Global Economic Prospects and the Developing Countries. December 2001. www.worldbank.org/prospects/gep2001/

globalization. Developing countries have assumed a more prominent role in multilateral trade activities since the Uruguay Round of trade negotiations, and arrangements affecting developing countries are likely to attract greater attention in future negotiations. For the EU, proposed reciprocal FTA agreements will provide significant new advantages for EU agricultural exports. 

Gene Hasha (202) 694-5168
gasha@ers.usda.gov