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African Continental Free Trade Area:

Challenges and Opportunities of Tariff Reductions

Abstract

African Union member States are in the process of establishing the Continental Free Trade Area (CFTA) in order to boost trade and economic growth and strengthen integration among African countries. A main objective is to eliminate tariffs on intra-African trade in goods. This study estimates costs and benefits of tariff reduction in four different scenarios. The results indicate significant welfare gains, output and employment expansion, and intra-African trade growth in the long-run. Gains are not distributed equally among member States. In the short-run, countries are likely to bear some tariff revenue losses and adjustment costs which may not be distributed uniformly across the African continent. Both, costs and benefits are reduced if sensitive products are exempt from liberalization. An unequal sharing of costs and benefits may hinder negotiation processes. Thus, sufficient flanking measures and flexibilities are needed to mitigate the costs of adjustment in member States.

Key words: Tariffs, Welfare, Adjustment Costs, Continental Free Trade Area (CFTA)

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Executive Summary

In 2012, the fifty-four member States of the African Union agreed to establish the Continental Free Trade Area (CFTA) by 2017.

The CFTA is widely seen as a crucial driver for economic growth, industrialization and sustainable development in Africa. Despite the opportunities, challenges need to be addressed. Fears of significant tariff revenue losses and an uneven distribution of costs and benefits are among the main obstacles to the continent's integration. Flanking measures and flexibilities should be explored for a fair sharing of costs and benefits, to reduce adjustment costs and to attain the full long-term benefits of the CFTA.

In the long-run, trade liberalization in the CFTA lowers trade costs and allows consumers to access a greater variety of products at lower prices. Lower costs for imported raw materials and intermediate inputs increases competitiveness of downstream producers and promotes the generation of regional value chains. Trade liberalization also allows firms to access a large continental market and gain from economies of scale. In the long run, increased competitive pressures may improve firm efficiency. However, market consolidation may arise when smaller firms are exposed to stiffer competition.

While most of the potential benefits of trade liberalization accrue in the long run, short-run structural change through the relocation of labour, capital and other factors of production entails costs of adjustment. Short run and long run effects of trade agreements should therefore be distinguished.

Crucial private adjustment costs arise from temporary unemployment and lower wages in declining sectors, and similarly from underutilized capital. Costs of upgrading labour skills or training for new skills are also part of private adjustment costs. For the public sector, lower tariff revenues are the most pronounced concern in many developing countries. Still, a rise in costs of social safety nets and implementation costs of trade reforms remain significant public costs of adjustment.

Most empirical studies in the existing literature on trade liberalization tend to find that long-run gains outweigh short-run adjustment costs.

The study first considers two different long-term scenarios for the CFTA. In a second step, it looks at the implications of different tariff reduction modalities on short-term adjustment costs.

We use the Global Trade Analysis Project (GTAP) computable general equilibrium (CGE) model to assess the long-run outcomes of the CFTA under different scenarios.

Scenario 1 (full FTA) assumes that all tariffs will be fully eliminated in the CFTA. Our long-term simulations find substantial welfare gains of about US$ 16.1 billion, even after deducting US$ 4.1 billion of tariff revenue losses. The tariff revenue loss is equivalent to 9.1 per cent of current revenues. GDP is expected to grow by 0.97 per cent and total employment rises by 1.17 per cent. Also the vast majority of individual countries gains from the CFTA. Intra-African trade is estimated to grow by 33 per cent and Africa's total trade deficit is cut in half.

Scenario 2 (Special Product Categorization) exempts certain sensitive products from liberalization. Assuming that the sector with the highest current tariff revenue (high tariff and intra-Africa trade) would be exempted, our simulations show a significantly reduced overall welfare gain of 10.7 billion US$ in the long-run. At the same time, tariff revenue losses are reduced to 3.2 billion US$ (7.2 per cent of current revenues). GDP and employment growth are lower at 0.66 and 0.82 per cent, respectively. Intra-African trade is expected to grow by 24 per cent, but Africa's overall trade deficit only shrinks by 3.8 per cent.

Scenario 2 results in fewer countries with tariff revenue losses beyond 20 per cent. However, there is a risk that the exclusion of certain sectors by some countries will negatively impact on the export development interests of other countries. In fact, the simulations show that more countries experience welfare losses if sectors with high current tariff revenue are permanently excluded from liberalization.

In both long-term scenarios, the largest employment growth rates are found in manufacturing industry followed by some services and agriculture subsectors. All sectors grow, with the exception of a stagnant mining sector. This is in line with the CFTA objective for structural transformation and industrialization.

In the short-run, adjustment costs also depend on the modalities of tariff reductions. We distinguish three types of tariff reduction modalities.

Linear tariff cuts: In this modality, all tariffs are gradually reduced by equal shares every year until full elimination (e.g. annual tariff reductions by 20 per cent, over five years). Linear tariff cuts have the advantage that the phase-in does not further distort the efficient allocation of factors and resources. The homogenous tariff reductions across all sectors may ensure that factors efficiently move in the direction of the final equilibrium. However, this approach takes away the countries' flexibility to postpone adjustment costs in sensitive sectors and to prepare these sectors for increased competitive pressures.

Progressive tariff cuts: This modality divides products into different groups that are liberalized at different speeds (e.g. a certain share of tariff lines is eliminated immediately, a second group of products is liberalized over a period of 5 years and a third group over a period of 8 years). This approach allows member States to eliminate tariffs for different sectors with more flexibility. There is a risk that the immediate increase of competition in non-sensitive sectors may lead factors to move towards still protected sensitive sectors. However, when also the sensitive sectors finally liberalize, those additional production factors may have to move once again. These temporary false incentives may increase overall adjustment costs. However, this approach provides more policy space with respect to defensive interests and allows countries to manage liberalization in their preferred ways.

Two-phased linear cuts: This modality immediately eliminates a large share of tariffs and eliminates the rest over several years. This "shock therapy" adjustment process is likely to be particularly challenging for SMEs and least developed countries. This option leaves a low level of policy space to countries but creates a high level of predictable export opportunities right from the beginning.

Each of these three transition modalities could also include permanent product exemptions. While short-term effects and adjustment costs follow the same logic as described above, the long-term benefits would be reduced as estimated for scenario 2 (Special Product Categorization),

The advantages and disadvantages of these scenarios need to be carefully considered with regard to long-term effects as well as short-term adjustment costs. Fully exempting some products from liberalization (Scenario 2) may reduce tariff revenue losses, but lowers aggregate welfare gains and the overall ambition of the CFTA. Between scenarios for the transition period, flexibilities and policy space have to be weighed-up with predictability, efficiency and speed of the adjustment process. While all scenarios lead to aggregate gains, policymakers need to be aware that structural change produces winners and losers across sectors and firms. In particular, a lack of labour mobility between sectors is a key challenge for many developing countries. However, with adequate flanking policies and social safety measures, the CFTA has an immense potential to promote equitable and inclusive growth.

1. Introduction

In January 2012 fifty-four African countries agreed to establish the Continental Free Trade Area (CFTA) during the 18th Ordinary Session of the Assembly of Heads of State and Government of the African Union (AU) in Addis Ababa, Ethiopia. The member States aim at launching the CFTA by the end of 2017 and create a single market for goods and services.[1]

The agreement has ambitious long term goals in deepening integration among AU member States, promoting the African Economic Community as envisaged in the 1991 Abuja Treaty of the Organization of African Unity and realizing Africa's Agenda 2063 to build a prosperous and united Africa. Among the main objectives of the CFTA are the facilitation, harmonization and better coordination of trade regimes as well as the elimination of challenges associated with multiple and overlapping trade agreements across the continent. It is hoped that integrated African economies can strengthen competitiveness of the local industries, realise economies of scale for domestic producers, better allocate resources and attract foreign direct investments.

The CFTA is aimed at helping African countries to boost economic and trade growth, transform their economies and achieve SDGs and AU Agenda 2063

The CFTA is widely seen as an important opportunity for African countries in an increasingly globalized world. Eliminating tariffs can help African countries boost economic growth, transform their economies and achieve the SDGs. Furthermore, the positive impact of the CFTA is expected to be even greater if non-tariff measures are addressed, informal trade is integrated into formal channels and the agreement includes trade in services as well (see Kituyi, 2016).

Box1. Continental Free Trade Area and Opportunities for the African Countries

The CFTA offers significant advantages for African countries if it leads to deeper integration among African countries. The potential benefits include:

1. Creating bigger and integrated regional market for African products.

2. Permitting producers to benefit from economies of scale and to access cheaper raw materials and intermediate inputs.

3. Improving conditions for forming regional value chains and integrating to global value chains (GVCs).

4. Allowing consumers to have access to cheaper imported products from other African countries.

5. Leading to better allocation of resources and faster economic and trade growth.

6. Catalyzing the structural transformation of the countries from resource and low technology based economies to more diversified knowledge based economies.

6. Eliminating some challenges associated with multiple and overlapping trade agreements in Africa (spaghetti bowl).

7. Encouraging both intra-African and external direct capital flows to African countries.

8. Stimulating cooperation in other areas such as technology transfer, innovation, investment and continent-wide infrastructure development.

Source: Authors.

[1] See AU website for further information (http://www.au.int/en/ti/cfta/about).

Even though the CFTA offers significant opportunities for achieving sustainable development, numerous challenges and threats are ahead for the member States. Fear of experiencing significant tariff revenue losses and an uneven distribution of costs and benefits are among the main obstacles to the continent's integration. Countries with large productive capacities in manufacturing may experience significant economic growth and welfare gains while small economies and LDCs may face substantial fiscal revenue losses and threats to local industries (Kituyi, 2016). An uneven distribution of benefits and costs among member States may prolong the negotiations and hinder its implementation. Sufficient flanking measures and flexibilities are therefore needed to enable the redistribution of benefits and a fair sharing of costs by member States. In order to deal with these potential challenges, the AU member States are considering different tariff reduction modalities and other mitigating mechanisms.

Fear of significant tariff revenue losses and possible uneven distribution of other costs and benefits are two main challenges ahead of the CFTA.

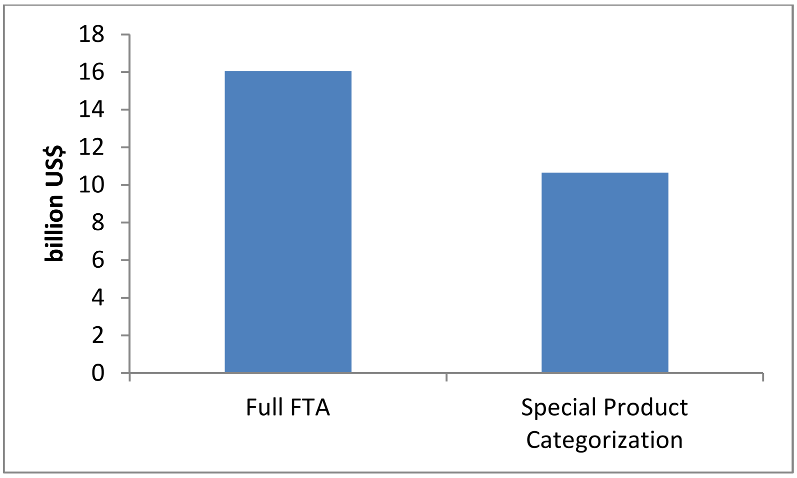
This paper analyses the potential adjustment costs and potential benefits of the CFTA tariff reductions under different scenarios. The study is organized in five sections. The second section discusses adjustment costs and long-run benefits of free trade agreements. The third section contains simulations about the welfare gains of tariff liberalization in the CFTA. Section four discusses the scenarios with respect to their adjustment costs and we conclude and discuss policy recommendations in section five.

2. Regional integration and adjustment costs

2.1. Benefits from regional integration in the long run

The assertion by many policymakers that regional integration can strongly contribute to economic development is supported by economic theory and quantitative evidence. We also show in section 3 that, in the long run and at the aggregated level, African countries benefit from the CFTA (figure 1).

Figure 1. Welfare gains from regional integration in Africa (billion US$)



Source: GTAP estimates, see section 4.

After trade liberalization, countries specialise in the production of goods in which they have a comparative advantage vis-a-vis their trade partners. Specialization often raises output as the process allows better and more efficient use of productive resources in economies.

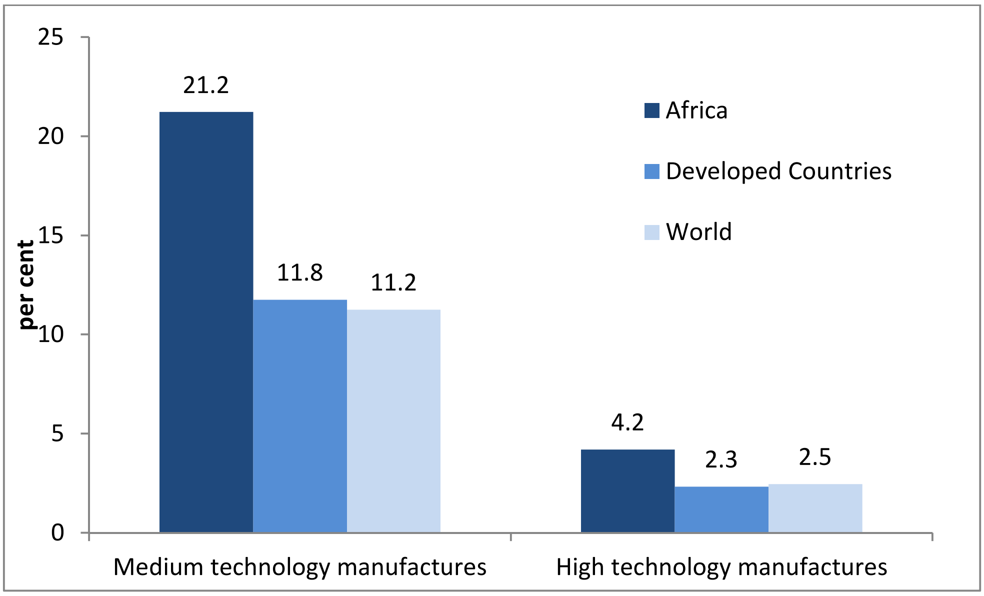
As trade liberalization comprises removing barriers on imports such as tariffs and quotas, it lowers import prices and thus consumer prices. Moreover, trade can also allow consumers to access a greater variety of products in domestic markets. Due to these two effects, trade liberalization may lead to welfare gains in the form of consumer surpluses in importing countries. Lower import prices may also reduce costs of imported raw materials and intermediate inputs for downstream producers in the importing countries. The cuts in production costs therefore increase competitiveness of domestic producers and allow countries to integrate into global value chains.

In addition to cost advantages, trade liberalization allows domestic firms to access to bigger markets and gain from economies of scale. Once the small local market constraints are lifted, trade may not only allow firms to grow faster but also to have better access to finance and technology in the world economy. These benefits may also bring challenges to countries. Large firms that are taking advantage of economies of scale may gain dominant positon in markets at the expense of SMEs. Market consolidation may arise when SMEs are exposed to stiffer competition during the transition. Thus, in order to ensure a smooth transition during trade liberalization, complementary policies such as consumer protection and competition policies need to be put in place.

As intra-African trade has higher skill and technology content than Africa's trade with others, the CFTA can improve diversification, and industrial product and technology content of AU member state exports.

In the long run, increased competition due to trade liberalizations may also lead to improved efficiency of domestic firms. Competitive pressures require firms to better use their resources, implement new technologies and innovate in order to survive under the new conditions. In some cases, trade liberalization may lead to structural transformation. Especially in the case of South-South trade, trade liberalization may improve skill and technology content of developing countries' exports. For example, intra-African trade has higher technology content than extra-African trade (figure 2). While medium and high technology manufactures account for 25.4 per cent of intra-African trade, they only account for 14.1 per cent of African countries' exports to developed countries. Similarly, according to UNCTAD (2011), intra-African trade has relatively higher industrial content than African countries' trade with the rest of the world.

Figure 2. Share of medium and high technology manufactures in African countries' exports to Africa, developed countries and the world (per cent), 2015



Source: UNCTADStat accessed on 18 November 2016. *Lall classification is used.

2.2. Short-run: Effects during transition

For these benefits from regional integration to occur, African countries have to reallocate resources within and between sectors. Most of the potential benefits of trade liberalizations accrue in the long run after economic resources have moved to their most efficient uses. This structural change brings with it costs of adjustment in the short-run. Potentially falling tariff revenues, for example, cause challenges for governments. Or, some sectors shrink and workers may face temporary unemployment. Such costs that are related to resources shifting from one sector to another, occurring in the period immediately after liberalization are called adjustment costs.

Short run and long run effects of trade agreements should therefore be distinguished. Even though there is no concrete line in the literature that separates short from long run dimension, the former includes transitional effects on economies during the adjustment period while the latter assesses the steady state equilibrium where resources have fully adjusted to a new equilibrium.

Sometimes transition periods can be very long and adjustment costs high in some economies. The period often depends on the type, depth and extent of international trade agreements as well as flexibility and structure of national economies. Governments are often highly concerned about mounting adjustment costs of trade agreements even though they are usually transitionary. Therefore, we discuss the cost of trade agreements in both short and long-run dimensions.

A typical link between short-run adjustment costs and long run benefits is shown by using a simple graph taken from Francois *et al.* (2011) (figure 3, left panel). Y_0 and Y_T are the initial and long-run levels of output respectively. Over time, output follows a U-shaped path (Y(t)) first decreasing below the initial level (Y_0) but then gradually converging to the long-run equilibrium (Y_T). The authors refer to the adjustment cost as the fall in the level of output (Y(t)) below the initial level of output (Y_0) during the first t_{y0} periods of the adjustment. In other words, adjustment costs are the fall in national income after a trade agreement due to sluggish adjustment of the economy to structural changes.

The transition process can be very sluggish if product and factor markets are not sufficiently flexible. This may not only prolong the duration of the transition but also reduce the long-run benefits. According to Davidson and Matusz (2004a), labour markets are characterized by frictions and exporting sectors are subject to congestion externalities. Therefore, temporary terms of trade shocks can lead to an inferior equilibrium with lower employment and output (figure 3, right panel). This risk justifies use of government intervention during the transition period.

Countries may face adjustment costs during the transition period especially if their economies are not flexible enough. In the long-run, however, FTAs are expected to bring higher output growth and welfare gains for participating countries that can compensate short-run losses.