



# Trade Hot Topics

## EU Policy Changes Pending the EPA Deals: Implications for African Global Value Chains

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### Background

A revised date has been set for the removal of autonomous preferences (October 2014), by which time African, Caribbean and Pacific (ACP) countries which have not yet agreed and taken necessary steps towards ratification of an Economic Partnership Agreement (EPA) with the European Union (EU) will be downgraded to the Generalised System of Preferences (GSP). This will result in an increase in tariffs for ACP countries that are not Least Developed Countries (LDCs), as they begin to export under the Standard GSP scheme if they are non-LDCs.

This issue of *Commonwealth Trade Hot Topics* uses a case study of Kenya to illustrate some of the broader implications of EU GSP regime changes, which may also have relevance for other ACP members, and regional economic communities (RECs).

### The cut flower GVC in Kenya

Kenya is an interesting case study because one of its key export-oriented industries, and major global value chains (GVC) – the cut flower industry – could be adversely affected by an increase in tariffs if it fails to secure agreement on an EPA, either individually on a country or collectively on a regional basis. There are other concerns regarding the ability of producers in Kenya to absorb the increase in tariffs that will result

from being downgraded to the EU's GSP, and the potential trade shifts that may arise if buyers choose to import from other lower cost producers that export without duties such as LDCs within the region (or elsewhere – including competitors such as Ethiopia). Use of the GVC perspective helps to provide a lens through which to analyse how sourcing strategies may shift as a result of whichever of these trade policy changes seem most likely come October 2014. We describe how and why below.

### *Firm organisation and co-ordination*

Producers trading cut flowers, and flower products such as bouquets and summer flowers, supply either directly to retailers predominantly in the UK, or to Dutch auction houses for purchase by buyers (and their subsequent distribution across supply chains). Some authors posit that it is easier to access auctions via an intermediary, compared to accessing retailer led supply chains. Sales through direct relationships, not through auction houses, offer a stable demand with generally higher returns (Ksoll et al, 2013). However, direct relationships with retailers also mean greater dependency on the buyer as flower exporters tailor their products to the client. As noted by Ksoll et al (2013) exporting via auctions reduces this dependency but prices vary substantially throughout the season. Hence, only the largest firms are able to

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sustain their presence within the auction house. This is through maintaining supply but also shouldering losses when prices decline.

It could be assumed that sales to auction houses would be – in terms of a hierarchy of GVC governance (Gereffi et al, 2005) – a case of market governance. However, in practice it seems that such sales, at least from some suppliers, exhibit a more hierarchical structure of governance. This is because of overlapping ownership structures between important actors in Dutch auction houses and some of the Dutch-owned flower producers based in Kenya. The number of cut flower auction houses has been on the decline in the EU. The two most important ones, located in the Netherlands, merged in 2007 and essentially now operate as a members club run by the major suppliers some of whom own production facilities in Kenya. As discussed by Taylor (2010), this leaves only two auction companies of international significance: The FloraHolland Group in the Netherlands and Landgard in Germany.

Hence, although two different major marketing strands exist – to Dutch auction houses, or European retailers – the lead firms within them exert a high degree of explicit control on their suppliers. These recent trends are reflective of broader ones, including how the share of global trade controlled by lead firms has increased over time. Latest estimates suggest that 80 per cent of global trade is now co-ordinated by transnational corporations, including through intra-firm trade as well as non-equity modes and under contractual relations.

Although lead firms can typically pick and choose from many different suppliers as well as dictate the prices, some firms located in some countries will ultimately always be preferred suppliers because they are subsidiaries of lead firms. Other firms, including those that trade within non-equity modes of international production, may instead become preferred suppliers over time because they are able to fulfil buyers' requirements, or because they have been integrated within supply chains via intermediaries. The evidence reviewed in Keane (2013) suggests that this is indeed the case in Kenya. There are different types of firms in operation in the cut flower GVC in Kenya, characterised by different ownership structures that face different upgrading challenges and trajectories.

### Potential increase in costs of exporting

Kenya is a major exporter to the EU across the overall category of cut flowers (HS0603). Most of these are destined for the Netherlands (70.9%), the UK (18.7%)

and Germany (6.4%). At present, under the Cotonou Partnership Agreement (CPA) it pays no tariff and neither do the other members of the East African Community (EAC) for products exported under this category. If all countries agree an EPA, this status quo will not change. Because LDCs can export under the 'Everything but Arms' (EBA) regime which provides duty and quota free (DFQF) market access for these countries, they will not be affected by an increase in tariffs if they do not reach agreement on an EPA with the European Union.

However, the status quo will change for Kenya should it not sign and ratify an EPA in time and be downgraded from the CPA to the EU's 'standard' GSP as opposed to the EBA tranche of the GSP to which all other EAC members plus significant regional competitors like Ethiopia are eligible.

This will affect the following products which will experience an increase in tariffs payable of between 5 and 6.5 per cent under the EU's standard GSP: (i) HS 06031100 fresh cut roses and buds, (ii) HS 06031990 fresh cut flowers and buds, and (iii) HS 06039000 dried, dyed, bleached, impregnated or otherwise prepared cut flowers and buds.

These products accounted for almost 70 per cent of the total value of cut flowers (HS0603) from Kenya in 2012. Donors such as the UK's Department for International Development (DFID) under its Trade in Global Value Chains Initiative (TiGVC) are already supporting the horticulture GVC in Kenya, of which cut flowers are a sub-sector. This includes working with lead firms and retailers to facilitate social as well as economic upgrading processes for their suppliers.<sup>1</sup> Within the analytical framework developed, economic upgrading is defined as an increase in export unit values and market shares; social upgrading is defined as improvements in wages and employment levels.

Although one might be surprised that these interventions have not fully considered the effect of trade policy changes on supply chains, the reasons for this may actually be rather simple: the effect of an increase in tariffs may not be such a challenge for large vertically integrated firms that deal directly with retailers. It is more likely to be a challenge for smaller and more medium sized firms, which are also the same type of firms likely to be domestic rather than foreign owned. These firms which are represented by producer organisations such as FPEAK are lobbying hard to reach an agreement on an EPA, which will mean not only that an increase in tariffs on the industry is avoided, but also that market access is

secured (since a free trade agreement – FTA – is more stable than the EU’s GSP, which can change as the most recent reform process of 2014 has shown).

### **Potential effects**

Given firm level heterogeneity we would expect some differences between firms regarding their ability to absorb any related trade shock which may arise should Kenya proceed not to sign an EPA and be downgraded to the EU’s GSP. The logical postulate is that larger firms and those more directly integrated with buyers may be better able to absorb any increase in tariffs. This is not only because of scale effects but also because the tariff margin increase could potentially be borne by buyers rather than producers.

The increased cost of exporting could, however, also be offset elsewhere. Hence, it could potentially affect less integrated firms, and those that operate under other contractual arrangements. Limited scale effects as well as the inability to offset an increase in costs could generate ripple effects within supply chains. Smaller and more medium sized firms, and their workers, could therefore be adversely affected. These are the same types of firms that already face particular challenges related to meeting private voluntary standards and obtaining mutual recognition within developed country markets.

The potential increase in tariffs could be distributed across the supply chain in a number of ways, and either result in no change in trade flows, or trade shifts towards other more competitive producers. As analysis undertaken in Stevens et al (2011) has shown there are a number of different scenarios which may arise from an increase in tariffs. Should producers remain competitive despite the tariff increase, in principle there may be no effect on volumes of cut flowers imported from Kenya. However, the structure of the industry in Kenya and the types of firms involved means that this scenario is unlikely.

The potential for trade shifts may arise if the increase in tariffs on Kenyan imports of cut flowers results in a reduction of imports from Kenya and a subsequent increase from other suppliers, including from the EAC or elsewhere (including Europe). LDCs in the EAC could potentially help to make up the shortfall but this is by no means guaranteed: capacity constraints may mean that other competitive producers are more likely to.

Even with favourable market access many LDCs lack the productive capacity, as well as capabilities to fulfil demand. Hence, the provision of aid for trade (AFT) remains an important issue, with or without an EPA. Kenya is already well integrated into the cut flower GVC and to some extent is a rather mature player. Nevertheless, given that the industry there has been established for more than a decade, should all countries agree to an EPA the rules of origin (RoO) applicable may serve to bring other producers within the region into this production network and regional cluster.<sup>2</sup> But is this enough to incentivise LDCs to agree an EPA?

### **Need for trade related adjustment**

There will be indirect, as well as direct effects on LDCs within RECs such as the EAC, if a regional EPA is not agreed, but Kenya signs and ratifies. Should Kenya proceed to sign and ratify an EPA by 2014, there may be a need for trade-related adjustment in LDCs for the following reasons, which all have the potential to affect existing global and national value chains, as well as future ones.

- LDCs may be affected if the EPA gives Kenya preferential access to the EU for goods that currently face MFN (most favoured nation) tariffs under the EU’s autonomous regime that ends in 2014. This could result in an erosion of the EBA preferences of the LDC members of the EAC.
- A customs union by definition includes a common external tariff which will be removed if Kenya liberalises towards the EU but other EAC members do not. Hence there could be other indirect effects on the national as well as regional value chains in operation.
- There are differences in the rules of origin applicable to EPA signatories compared to those that export under the GSP which could affect regional value chains.

Even if agreement on the EPA is reached, there is a need to consider the ability of producers within the EAC to deal with the resultant trade shock if tariffs towards the EU fall, which could affect the drivers of national, as well as regional, value chains in operation. In this sense it is important to bear in mind that the EPA includes a raft of behind the border measures as well as the removal of restrictions on border

<sup>1</sup> This intervention has been informed by the results of the work carried out under the ‘Capturing the Gains’ project; see: <http://www.capturingthegains.org/>

<sup>2</sup> The working or processing carried out there has to be more than the ‘insufficient working or processing’.

measures such as tariffs. EAC negotiators are clearly aware of this. How these issues will be resolved, however, remains quite unclear.

### Concluding remarks

The trade and development community is increasingly recognising the importance of harnessing GVCs for development, and this includes considering both how to enter as well as upgrade within GVCs. The discussion related to trade policy, particularly at the regional level, is rather muted though. For example, statements were agreed at the most recent Bali WTO Ministerial (known as MC9) on the need for trade facilitation. But there remain formidable implementation challenges regarding the provision of AfT, as well as its allocation.

Most of the real trade policy action particularly for the ACP over the coming months will be occurring at the regional level. The inability of the ACP and the EU to secure agreement on a new trade regime as encompassed in EPAs (intended as a form of South–South–North regional integration) has meant that deadlines have shifted from what was originally envisaged (to be concluded by 2007).<sup>3</sup> The negotiation process itself has meant the fragmentation of the ACP into groups of countries divided into regions, which include those that have either initialled reciprocal FTAs (an EPA) or which have not because they are granted non-reciprocal DFQF under the GSP because they are LDCs.

The implementation of some of the already initialled agreements may prove to be disruptive to existing, as well as potential, trade and investment patterns on an intra-regional basis. Whatever outcome is finally achieved by October 2014 is likely to have implications for the future of development and regionalism across ACP members that have so far not signed and ratified an EPA (the Caribbean – CARIFORUM – being the only ACP region so far to do so). These trade policy changes have the potential to affect existing value chains, as well as shape the

<sup>3</sup> Aid relations between the ACP and EU will continue until 2020.

development of future ones. If Kenya proceeds to initial the EPA without bringing other LDCs within the EAC on board, there could be both direct as well as indirect effects on other value chains in operation within the region which have not been explored in this paper but which deserve further attention.

Although donors have worked hard in the past (particularly in the case of Kenya), to ensure the inclusion of small and more medium sized firms within horticulture supply chains, the case study of Kenya has been used here to draw attention to how existing GVCs could be hit by trade policy changes. Should there be a failure to reach agreement on an EPA, sourcing strategies are likely to adapt to offset an increase in the costs of exporting because of an increase in tariffs. These changes could prompt the downgrading of some firms within the cut flower GVC as opposed to facilitating the social and economic upgrading currently being promoted by donors.

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