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The EU-Georgia Trade Agreement: The Impact on Agricultural Trade and Welfare

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The EU has signed new agreements with Ukraine, Moldavia, and Ukraine, the so-called Deep and Comprehensive Free Trade Agreement (DCFTA). This policy brief only focuses on Georgia to exemplify the mythology and some important specifics of the participating countries that differ somewhat, but are important for assessing the impact. The agreement with Georgia became effective in September 2016; therefore, accurate estimation of the quantified effects was delayed for some time. This policy brief focusses on the free trade agreement on agricultural products. Georgia benefits from trade preferences for import to the EU and the EU likewise from exports to Georgia. It is foreseen that tariffs will be abolished completely in the future, but at present it is only Georgia which has abolished tariffs for imports from the EU. The EU has only reduced the World Trade Organization (WTO) bounded rates and, in addition, it still applies the so-called entry price system and even quotas for imports of garlic. Effects on trade might be important because the EU still highly protects agricultural imports and thus the standard of living for the 50 percent of Georgians living mainly from farming may improve. The findings are that Georgia may gain in total, if traders live in Georgia. The gain results from both redirection of Georgian exports from other destinations and additional exports of Georgian products. These additional exports to the EU may be replaced by additional imports from low price suppliers on the world market.

Introduction

In September 2014, a Deep and Comprehensive Free Trade Area (DCFTA) was set up as a part of the Association Agreement between the EU and Georgia, so that both partners could trade within the agreed upon rules, aiming to gradually integrate Georgia's economy with the European economy. The major aim of this policy brief is to identify the specifics of implementing the agreement that may contribute the greatest value from the point of view of the preferred countries.

This piece has been stimulated by the widely held belief that trade preferences include a move to free trade. Free trade is also considered to contribute to integrating the economies, leading to higher welfare, at least of the preferred countries. A team of experts has already calculated high welfare effects for the preferred countries (Movohab and Shportyk, 2016). In 2012, another team tried to assess the impacts for Georgia and Moldova (Ecorys, 2012). These studies have not discussed alternative methods for quantifying the impact of the agreement and, moreover, they missed the importance of the form of implementation of the agreement on the impact. One aim of this policy brief is to show that the impact of this agreement is related to the existent and chosen institutional framework; hence, the methods for assessing the impact have to be related to the institutional framework, including specific supporting policies. We intend to show that the direct effect of specific agreements may favor

Table 1: Tariff rates of the EU and Georgia before the agreement and with the agreement in percent

A. All products (Simple average)			B. Agricultural products (Simple average)		
	2013	**2015**		**2013**	**2015**
Georgia	0.6	0	Georgia	12.0	0
EU	6.5	0.0	EU	14.4	0 with exceptions

Source: WITS data base.

only some domestic or international companies and not the society as a whole. However, the dynamic effects, supported by enabling policies, could result in economy-wide welfare effects.

The content of the agreement

The trade agreement between the EU and Georgia is called the Deep and Comprehensive Free Trade Area (DCFTA). The name indicates that Georgia should be gradually integrated into the European Market. The agreement includes much more than agricultural trade liberalization. Nevertheless, we focus only on this policy change because the agricultural sector in Georgia is still the most important for overall employment. Article 26, "Elimination of customs duties on imports" of the association agreement, says: "The Parties shall eliminate all customs duties on goods originating in the other Party as from the date of entry into force of this Agreement except as provided in paragraphs 2 and 3 of this Article and without prejudice to paragraph 4 of this Article" (EU, 2014). The Agreement entered into force in July 1, 2016.

The demand for trade preferences only results from the protection of trade in the preference-granting country. Trade preferences are a child of protectionism. Hence, reducing protection for selected countries can generate positive effects in these countries; the original trade flows from Georgia to the EU were depressed due to higher protection for agricultural products in the EU. EU protection for agricultural products is significantly higher than for non-agricultural products (about 4.4 percent for non-agricultural products and 14.4 percent for agricultural products). Abolishing EU tariffs for imports from Georgia may have positive trade and welfare effects for Georgia.

However, it would be misleading to assess the impact of the trade association on the welfare of participating countries based only on trade information. Trade is not performed by countries, but by traders. Traders may be located in countries which are not the origin of exports. Moreover, traders have no incentives and can hardly be forced to hand over the profits due to the trade agreement.

In order to assess the impact of the preference agreements on the change in trade flows, the size of income, its distribution, and welfare, we use a partial market analysis taking into account the differences in trade protection for the individual products and the specific market situation for these products in the EU and in Georgia. We apply a comparative-static analysis in the first step in accordance with traditional trade theory. The rationale for these assumptions was to clarify the effect of abolished tariff rates on induced trade flows.[1] However, the trade agreement will not only lead to direct trade effects. Indirect effects caused by changes in domestic policies may augment the direct effects significantly.

The trade potential of Georgia for products with an exportable surplus in the EU

1. If a country produces an exportable surplus and domestic producers are only protected by import tariffs, these tariffs are redundant. The relevant domestic price is equal to fob parity prices. Actually, this is the reality for several EU products exported to the world market. Hence, lowering EU tariffs for imports from Georgia will have no effect of this set of products. Georgia will not receive higher prices for these products in the EU. It should be noted that this set of products includes narrowly defined goods with respect to time, location, and any other attributes which make the products different from the point of view of consumers at a specific point of time.
2. Of course this conclusion also holds for the EU. If Georgia is an exporter of the product considered internal prices are related to export prices and, hence, the trade agreement does not open the door for imports from the EU; the EU can only gain if EU export prices to Georgia are higher than exporting to other countries.
3. An interesting case concerns a situation in which Georgia is an exporter of a specific good to destinations other than the EU and the EU is an importer of this product. Tariff reduction will lead to a redirection of Georgian export destinations. Traders will gain from trade to the EU. Because Georgia will most likely not be able to cover the whole import gap of the EU and the EU may still have to import from countries which do not enjoy trade preferences, the EU price will not be affected by additional imports from Georgia. Likewise, the price in Georgia will not increase because there is only a redirection of the export flows.

[1] Georgia is an overall net importer of food products (by 30 percent of domestic production); the EU is an overall net exporter of food products, but a net importer or seasonal importer of some food products.

Trade potential if both parties are importers for the product under consideration

The most interesting case concerns a situation in which both parties are importers and, hence, domestic prices are equal to cif border prices plus tariffs. Because tariff rates are higher in the EU than in Georgia, abolishing tariffs may lead to profitable trade from Georgia to the EU. Internal prices in the EU will not be affected as long the EU still has to import from countries which do not enjoy trade preferences. Prices in Georgia may also remain unchanged because Georgia has to submit a certificate of origin for exports to the EU. Thus, additional exports to the EU will be compensated by additional imports from the world market by Georgia. Consequently, tariff revenue of Georgia will rise.

The effect on tariff revenue in the EU is the opposite; the EU has to import tariff-free from Georgia, and reduces imports from third countries by the same amount. The loss in EU tariff revenue is larger than the gain in tariff revenue for Georgia due to the positive difference in tariff rates between the two parties. Thus, the agreement will lead to a transfer of income from the EU to traders who deal with exports from Georgia to the EU. Of course, these traders may be of Georgian or foreign origin, including international companies. Is not at all clear that the Georgian society gains directly from this additional trade. However, there is a clear gain for Georgia; customs revenue increase as the exported volume will be balanced by imports from third countries. Thus, welfare of Georgia increases somewhat even if trading companies transfer the profit from additional trade to foreign countries. The loss to the EU due to the loss in tariff revenue will be significantly higher than the gain to Georgia as tariff rates of the EU are higher than those of Georgia. In any event, the transfer is not targeted and there are likely better alternatives to support the adjustment process for Georgia to prepare for EU membership.

Political strategies for adjusting the Georgian economy to the new trading conditions: Focus on dynamic effects

In spite of the reservations mentioned above, the DCFTA may contribute to significant positive effects in Georgia. The trade agreement will contribute to higher tariff revenue, even in the short run, making public funds available for promoting further economic reforms and stimulating agricultural production and trade. Moreover, enhanced openness of the country will stimulate internal adjustment and will promote agricultural and overall growth.

1. Georgia is not the only country that has benefited from special trade preferences. Therefore, we recommend investigating the experiences of other countries that have been highly successful in promoting growth in their agricultural sectors. Countries with outstanding experience include Brazil, Turkey, Serbia (concerning trade in raspberries), and Kenya (concerning trade in flowers). Organized tours to these countries for entrepreneurs and policymakers could serve as an eye opener and could give rise to new ideas.
2. The benefits from trade agreements mainly depend on the parties' willingness and ability to change. Better education and the opening up of economic alternatives will mitigate traditional constraints.
3. Benefits of the trade agreement could be enhanced by an enlarged market intelligence unit informing domestic and foreign agents on new trading opportunities. Improving education and offering specific seminars and information on EU markets, including market regulation, could be helpful.
4. The sown area in Georgia in 2014 was only 45.4 percent of that in 1990. The hypothesis is that insecure property rights are the main cause. The government of Georgia could contribute to growth in the agricultural sector by enforcing property rights.
5. The average farm size in Georgia limits market integration of its many small farms. There are some good examples available from other countries showing that setting up regional markets or collecting centers contributes to market integration of farms.
6. Border transaction costs can be reduced. Georgia has significantly improved its domestic enabling environment and cross-border regulations. However, costs to imports and exports are still significantly higher than for the average of Europe and Central Asia and for high-income OECD countries.
7. The shadow economy in Georgia has declined over the last couple of years, but the share of the informal economy in percent of Gross Domestic Product (GDP) seems to be high in rural areas, mainly due to high rates of unemployment. Integrating this part of the economy into the formal economy would give rise to increased transactions and, thus, a higher GDP growth rate that would help to boost trade.
8. Supporting the improved quality of products, in particular in the livestock sector, would widen trading opportunities with the EU.
9. It is a worldwide observation that trade in processed foods has grown significantly more than trade in pure agricultural products over the last decades. Georgia is still mainly trading unprocessed agricultural products. The country's competitiveness in the trade of processed foods has to be strengthened.
10. International trade in agricultural and food products is increasingly the result of sophisticated supply chains, where one country may be an exporter of raw material and an importer of the final product. Georgia has to build up supply chains for individual products, starting with those products which seem to have the best prospects in EU markets.

Further Information

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