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THE PROPOSED FREE TRADE AGREEMENT BETWEEN LEBANON AND THE EUROPEAN UNION COUNTRIES: EVALUATION AND RECOMMENDATIONS*

by

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Introduction :

In an attempt to carry out its newly designed policy toward the Mediterranean countries, the European Union proposed to Morocco, Algeria, Tunisia, Egypt, Jordan, Israel, Syria and Lebanon an association agreement which would replace the trade agreements currently in effect. So far three countries (Morocco, Tunisia, and Israel) have completed their negotiations and signed the new agreement, whereas Lebanon is still in the initial stage.

As proposed to these countries, the association agreement is essentially the same; it covers many areas, including cooperation in the social, cultural, financial, and economic fields. Regarding international trade in goods and services, of interest to us in our study, it calls for the following :

_1_. To create a free-trade area which would be temporarily limited to industrial goods.
_2_. To adopt mutual tariff reductions on agricultural products. Product categories and the amount of reduction would be decided by negotiation.
_3_. To postpone the liberalization of trade in services to negotiation in a later stage.

It is to be noted that, compared to the current agreement between the European Union and Lebanon (in force since 1978) the proposed agreement is a backward step. Under the current agreement, Lebanese industrial products have unrestricted access to the E.U. markets (no customs duties and no quantitative restrictions), whereas Lebanon is not bound to any preferential treatment regarding the E.U. industrial products. In contrast, the proposed free- trade agreement is based on reciprocity. Lebanon would have to refrain from using quantitative restrictions to protect its industries, and would have to grant the E.U. countries similar tariff exemptions, with one exception. While, on the E.U. side, exemptions would be immediately granted, Lebanon is allowed to phase its tariffs out during a 12-year period. In other words, the exemptions granted to Lebanon with no counterpart would have to be fully requited. The question is, therefore : why Lebanon would not keep the present agreement and decline the new offer? Most probably, if not certainly, the European Union would repeal the present agreement if Lebanon does not accept the new proposal.

Actually, under its Generalized System of Preferences (GSP), the European Union grants unilaterally 146 developing countries, including Lebanon, preferential tariff treatment for their industrial products. But there are two drawbacks in these preferences : (1) they do not always reach the full-exemption level; and (2) they could be unilaterally amended or withdrawn, without consultation with the concerned countries. In addition the European Union grants with no counterpart a duty-free treatment to the industrial products of 69 countries from the African, Caribbean and Pacific Group of States (ACP group) , under the Lomب Convention, and almost the same treatment to manufactures imported from Egypt, Jordan, Syria and Lebanon under the 1978 agreements, still in force . Moreover, and on the basis of reciprocity, the E.U. imports duty-free the industrial products from many European countries, including Switzerland, Norway, Hungary, The Czech Republic, The Slovak Republic, Romania, Bulgaria, Poland, Lithuania, Lettonia and Estonia; and also the following Mediterranean countries : Turkey, Cyprus and Malta; Morocco, Tunisia and Israel (under the new association agreements).

Within this overall trade policy of the European Union, is the interest of Lebanon in accepting the new association agreement which aims mainly at establishing, on a reciprocity basis, a free-trade area restricted to industrial products, or in rejecting the proposal and consequently (assuming the E.U. would repeal the 1978 agreement) remain without any agreement with the Union ? In order to be able to answer this question, we have to compare potential losses with potential gains.

We have used in our study the foreign trade statistics published by the Customs Higher Council, the 1994 Industrial Census Report, published by the Ministry of Industry in December 1995, and the final version of the Main Report on the Horizon 2000 Reconstruction and Development, prepared by the CDR, especially the Report's yearly estimates up to the year 2007 of Lebanon's GDP, imports, and the budget receipts and expenditures. On the basis of the data gathered, and using a number of assumptions we have estimated the potential yearly losses and gains during the period 1998-2007 to Lebanon from the proposed free-trade area. These estimates might not be accurate but they serve our purpose which is to give an idea about the impact of the proposed free-trade area on the Lebanese economy in general, and on the industrial sector in particular. The figures we have obtained show that if the structure of the Lebanese industry does not change, the losses would by far exceed the gains. and any possible gain is predicated on a significant increase in Lebanese exports to the E.U. countries, through new investments to be attracted by the Lebanese industrial sector. However, the achievement of such an increase would be impeded by the rules of origin, as they are set by the European Union in a protocol appended to the proposed association agreement. These rules, as we will see, have been tailored to the needs of the E.U. countries so as to make them practically hidden protection instruments. They would, to a great extent, restrict Lebanese exports to the E.U. markets.

Lastly, we notice that the proposal for the creation of a free trade area between the EU and Lebanon (as well as with the other Mediterranean countries) takes place in the context of a complete failure of all the attempts made so far by the Arab countries to integrate their economies. What would be the impact of the new EU-Mediterranean countries' free trade areas on regional economic cooperation is a question which also needs to be addressed.

This study consists of five sections :

- **In sections I and II,** we consider respectively the expected losses and gains to Lebanon from the proposed free-trade area

- **In section III,** we discuss the rules of origin, as set in the protocol appended to the proposed association agreement.

- **In section IV**, we review some of the rather positive facts that the EU-Mediterranean countries' free trade areas are expected to have on regional economic cooperation and integration.

- Finally, **in Section V**, we summarize and conclude our study with some recommendations.

SECTION I

Losses To The Lebanese Economy From The Creation Of a Free-Trade Area With The European Union.

The losses incurred by member countries in a free-trade area are due, according to economic theory, to trade diversion which we will discuss, together with the loss to the Lebanese economy from a drop in domestic output due to increased competition from the E.U. countries In addition we will study the loss of tariff revenues, although we do not consider them as an economic loss. This section shall therefore include the following issues :

1. Loss of import duties
2. Losses from "Trade Diversion".
3. Losses from the drop in domestic output due to intensified European competition.

1. Loss of Import Duties.

The gradual tariffs reduction on industrial imports from the E.U. countries, in accordance with the proposed agreement will end up by costing the Lebanese government a big part of its revenues from that source. As a result, there is no doubt that the government's plan to balance its budget by the year 2005 will be undermined. To stay on target, the government will have to impose new taxes and fees, mainly on imports.

We should point out, however, that the revenue losses from the removal of import duties on European goods do not represent a loss to the Lebanese economy, unless tariffs removal results in an increase in the prices[1] of imports. But this is almost impossible to happen with a country like Lebanon due to the small size of its economy, compared to the economies of E.U. countries. Therefore, the supply of exports to Lebanois infinitely elastic, which means that the prices of Lebanese imports from the E.U. countries (and the rest of the world) would not change whether they are submitted in Lebanon to high or zero tariffs.

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[1] **Calculated on a CIF (Cost + Insurance + Freight) basis**

A. Present Status of Import Duties in Lebanon.

Beginning 1996, the Lebanese tariffs have been reclassified according to the Harmonized System nomenclature. Their rates can be considered as moderate compared to those of other developing countries. Although they range from zero to 100 percent, most tariff items are subject to duties that do not exceed 30 percent.[2] The un-weighted average of the Lebanese tariffs is 10%. This is also the most frequent and the median rate. Weighted by the Lebanese imports in 1996, the average rate obtained is 15.29%. For simplification, we will consider it in this study to be 15%.

B. Impact on Budget.

Customs duties, in Lebanon as in other developing countries, play a major fiscal role; in 1996, tariff revenues reached 1631 billion Lebanese pounds or about 46 percent of budget revenues. The creation of a free trade area between Lebanon and the European Union will result in a sharp decrease in revenues from customs duties for the following reasons. First, because the share of the E.U. countries in Lebanon's total imports is very important (about 50 percent); and, second, because this share will rise significantly, when import duties on E.U. goods will be phased out, while remaining unchanged on imports from the rest of the world.

To give an idea about how the proposed free-trade area would affect revenues from customs duties, we start from the fact that the domestic market, as far as manufactured goods (including processed foods) are concerned is almost equally divided between domestic production, imports from E.U. countries, and imports from the rest of the world. That is, the share of each category of goods is currently the third of the Lebanese market[3]. On the other hand, we shall make two assumptions :

First, import duties would be reduced by the same amount until they are phased out over a period of 10 years, from 1998 to 2007. As a result, the average customs duties on goods imported from E.U. countries (currently 15%) would drop as shown in Table 1.[4]

Table 1
Average Import Duties on Imports from E.U. countries
(in percentage)

Year	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Average customs duties on imports from E.U. countries	13.50	12.00	10.50	9.00	7.50	6.00	4.50	3.00	1.50	0

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[2] For further information about protective duties in Lebanon see Appendix III

[3] For further information, see Appendix I

[4] We have adopted this tariffs reduction schedule, on E.U. products, because it does not conflict with the proposed European Free-Trade agreement with Lebanon, and because it allows us to use the findings of the Economic Model on the Lebanese Economy, adopted by the CDR in its report on the reconstruction and development of the country.

Second, we assume that the elasticity of substitution of the E.U. countries products in the Lebanese market is equal to 2. In other words, we assume that for every 1 percent point drop of tariffs on imports from E.U. countries, their share in the Lebanese market will rise by 2 percent. We also assume that this increase in imports from the European Union will drive down imports from other countries, and cause a decline in domestic production in the same amount.[5] This is what we need for the moment Therefore, we assume that the share of each of these three groups (domestic production, the E.U. countries, and the rest of the world)will change as shown in Table 2.

Table 2
Structure of the Lebanese Market by Origin of Products
(in percentage)

Market share	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
E.U. countries	33.30	36.30	39.30	42.30	45.30	48.20	51.30	54.30	57.30	60.30	63.30
Domestic Production	33.30	31.80	30.30	28.80	27.30	25.80	24.30	22.80	21.30	19.80	18.30
Rest of the World	33.30	31.80	30.30	28.80	27.30	25.80	24.30	22.80	21.30	19.80	18.30
Total	99.90	99.90	99.90	99.90	99.90	99.90	99.90	99.90	99.90	99.90	99.90

Consequently, Lebanese imports will be shared between the E.U. countries and the rest of the world in the following manner :

Table 3
Breakdown of Lebanese imports by country of Origin
(in percentage)

Market share	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
E.U. countries	50.00	53.30	56.50	59.50	62.40	65.20	67.80	70.40	72.90	75.30	77.60
Rest of the World*	50.00	46.70	43.50	40.50	37.60	34.80	32.20	29.60	27.10	24.70	22.40
Total	100	100	100	100	100	100	100	100	100	100	100

*** These figures were obtained from Table 2 by dividing the share of E.U. countries and that of the rest of the world by the sum of both shares for the years 1997-2007.**

If Lebanon maintains its tariffs at their current level on imports from the rest of the world and gradually phase them out on imports from E.U. countries according to Table 1, the average ratio of tariff revenues to the total value of imports from all sources will be as follows :

Table 4
Evolution of Import Duties
during the Transitional Period of Implementation
(In percent of total imports)

Year	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Ratio of tariff revenues to the total value of imports	14.20	13.30	12.30	11.30	10.10	8.90	7.60	6.30	4.80	3.40

Note that the figures in this table are based on the average import duties on European imports (see Table 1), and, on the assumed 15 percent import duties on imports from the rest of the world. Each is assigned a weight equal to its share in total import.

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[5] **Although we did not base both assumptions on any study, we believe that they are operational enough to five an idea about the impact of a decrease in import duties on total imports, and on domestic production.**

This comes at a time when the government budget is suffering from a large deficit, estimated to be around 51% of total expenditures in 1996. The reduction of this deficit, and ultimately its elimination, is one of the main objectives of the economic policy in Lebanon. It is expected, in the Horizon 2000 plan prepared by the CDR, that the Lebanese government would be able by the year 2005 to balance its budget, by taking a number of measures, including an increase in the tax burden which will have to rise from 18.9% of GDP in 1995 to 27.10% in 2005. If we assume that the structure of government revenues will remain unchanged, i.e. that all revenue components would rise by the same proportion, the Horizon 2000 plan expects that, in order to balance the budget by 2005, customs duties will have to increase as shown in Table 5.

Table 5
Average rate of Import Duties implied by the Horizon 2000 Plan
(in percentage)

Year	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Average Rate of import duties implied by the Horizon 2000 plan	16.60	17.60	18.40	19.30	19.60	19.90	20.00	20.30	20.50	20.60

If we compare the rates in Table 5, as implied by the Horizon 2000 Plan in order to balance the budget, with the level of duties shown in Table 4 (i.e. the value of duties which, according to our assumption, would be collected on Lebanese imports when the free-trade agreement will be in effect),we find a negative difference, which will increase as shown in Table 6.

Table 6
The difference between the Import Duties under the Proposed Agreement and those implied by the Horizon 2000 Plan
(in percentage)

Year	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
The difference	-2.20	-4.30	-6.10	-8.00	-9.50	-11.0	-13.4	-14.0	-15.7	-17.2

This increasingly negative difference between import duties under proposed free-trade agreement and those implied by the Horizon 2000 Plan will make the balancing of the budget an impossible task, as shown in Table 7.

Table 7
Ratio of the Overall Budget Balance to GDP
(in percent of GDP)

Year	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
According to the Horizon 2000 Plan	-13.7	-10.8	-8.1	-5.9	-4.0	-2.5	-0.4	1.3	2.9	4.1
After the creation of a free-trade area with E.U.	-15.4	-13.9	-12.5	-11.7	-10.8	-10.5	-9.4	-8.9	-8.4	-8.4

C. Alternative taxes

In order to make up for the potential revenue losses which would arise from the removal of import duties under the proposed free-trade agreement, the Lebanese authorities will have to find new sources of revenue. But we do not expect these alternative revenues to come from raising existing direct taxes nor from imposing new income or capital gain taxes. This would be, first, in contradiction with the government policy -the present government, at least- which lowered income taxes to attract foreign capital and promote new investments.

Second, in Lebanon direct tax revenues are, as in most developing countries, much less than tariff revenues. In the 1996 budget plan, for example, the share of direct tin total tax revenues is less than 18%, whereas customs duties alone represent 56% of that total. Therefore, no matter how high is the rise in direct taxes, their revenues would still be far from offsetting the loss of tariff revenues. The answer could be then to raise indirect taxes on goods and services. Regardless of the type or level of new taxes on services, there is no reason for the government, to refrain from imposing on goods new taxes equal to present tariff revenues or to the level of future fiscal needs, especially that the budget is running an increasingly large deficit. If the Lebanese authorities, as we expect, decide to replace every reduction in tariffs with a new domestic tax on goods (e.g. a value added tax), such a tax, which would probably have different rates and would apply equally to both domestic output and imports as specified by the proposed free-trade agreement which prohibits, in terms of domestic taxation any discrimination between domestic products and imports. But if such a new tax is adopted (it should not apply to exports), it would be collected mainly from imports (in a proportion of about 93%), and only marginally from domestic production (about 7% only).[6]

We can therefore conclude that the new tax rates will be very close to the reductions in import duties, if the purpose of the new tax is to generate revenues equal to those lost from customs duties. This means that the establishment of the free-trade area would have little or no impact on domestic prices in Lebanon. We will see later, this point is very important. As a result, the financial role of customs duties would remain unchanged, but with another name. This is what happened in Greece, after joining the European Union. The share of customs duties in the budget revenues dropped to 0.1% in 1993, while the share of indirect taxes and fees on goods and services rose from 31.6% in 1980 to 68.3% in 1993.[7]

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[6] **Whether Lebanon decides to exempt from customs duties the E.U. products only, or to include in the exemption the rest of the world, we expect that the share of imports in the Lebanese market would not be less than 80%. Consequently, what is left for domestic products would not exceed 20%, half as much (10%) is value added. The value added tax would be determined as follows : 80/90 = 89% on imports and 10/90 = 11% on Lebanese products. However, about 40% of domestic output comes from small production units, and these are very numerous according to the latest census by the Ministry of Industry. Taking this into consideration, we would conclude that tax collection from these entities is next to impossible. Let's assume as we expect, that the authorities will be able to collect 60 percent of the value added tax due on domestic output, and 100 percent of the same tax due on imports; as a result, revenues from this new tax would be in the proportion of (11 x 60)/100 = 7% from taxes on domestic output, and in the proportion of 100 - 7 = 93%, from taxes on imports.**

[7] **The World Bank, World Development Report 1995**

2. Losses to the Lebanese Economy from Trade Diversion

The phasing out of customs duties on imports from the E.U. countries, while keeping the duties unchanged on imports from the rest of the world, will increasingly induce Lebanese consumers to replace their imports from the world markets by more expensive imports from the E.U. countries. This additional cost of imports, which is a loss to the Lebanese economy (and an additional gain to the E.U. economies), will increase after each tariff reduction by Lebanon. For two reasons, this loss is expected to reach a very significant level at the end of the transitional period :

1) Although customs duties in Lebanon are relatively moderate in comparison with those of other developing countries, they remain quite high (their average rate is 15%).
2) Many E.U. member countries are technologically advanced; they produce goods which are, in general, close substitutes to those produced by the rest of the world.

In an attempt to give an idea about the potential loss to Lebanon from the diversion of a part of its imports in favor of the E.U. countries, we have prepared Table 8, which is based on Table 3 and on the value of Lebanese imports, as estimated in the Reconstruction and Development Plan, prepared by the CDR.

Table 8
Estimated Loss to Lebanon from Trade Diversion in favor of E.U. countries
(in Millions of dollars; in current prices)

Year	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Value of total imports(1)	10685	11816	13193	14448	15659	17347	19210	20206	22228	24464
Trade diversion in favor of EU countries(% of total imports) (2)	3.3%	6.5%	9.5%	12.4%	15.2%	17.8%	20.4%	22.9%	25.3%	27.6%
Value of trade diversion in favor of E.U. countries	353	768	1253	1792	2380	3088	3919	4627	5624	6752
Difference between duties on imports from EU countries and those on imports from the rest of the world (in %)	1.5%	3.0%	4.5%	6.0%	7.5%	9.0%	10.5%	12.0%	13.5%	15.0%
Estimated loss to the Lebanese economy from trade diversion(3)	5.3	23	56.4	107.5	178.5	277.9	411.5	555.2	759.2	1012.8

Notes :
(1) Taken from "Horizon 2000 for reconstruction and Development" prepared by the CDR(The final Report).
(2) These figures are derived from line 1 in Table 3, where we subtracted 50% from each number. The 50% is the European Union's share in Lebanese imports.
(3) This means that the difference between duties on imports from E.U. countries and those on imports from the rest of the world is equal to the difference between the prices from both sources.

The last line of Table 8 shows, as we expected, that the losses to Lebanon from trade diversion will gradually increase with the phasing out of import duties to reach a very high level at the end of the transitional period.

We should point out, however, that there is a way for Lebanon to avoid these potential losses. Each time there is a reduction of Lebanese tariffs on goods from the E.U. countries, a similar reduction, in the same proportion, should be applied to imports from the rest of the world. This would circumvent the preferential treatment of E.U. imports, prevent trade diversion, and avoid losses to the Lebanese economy.

This solution is not in contradiction with the proposed free-trade agreement, which leaves to each party the freedom to set its external tariffs according to its own interest. Therefore, if the Lebanese negotiating team cannot obtain from the E.U. a compensation for the trade diversion losses(given that the losses to Lebanon are gains to the E.U. countries), Lebanon -in case it decides to joint the proposed free-trade area- should seriously envisage the liberalization of its imports from the rest of the world, along with the liberalization of its imports from the E.U. countries.

3 - Losses to the Lebanese Economy from a decrease of its domestic production.

With few exceptions, Lebanese industries benefit from protective tariffs. Raw materials and intermediate goods needed for domestic production are subject to low customs duties (2-5% in general), while competing imported goods are subject to a range of high customs duties (15-35%). There is no comprehensive study about the effective rates of protection enjoyed by Lebanese industries. However, since there is on average a 49 percent value added in the domestic industries, according to the December 1995 industrial survey by the Ministry of Industry, and if we consider that imported industrial goods similar to domestic products are subject to an average 20% tariff, with only 2% on intermediate goods, the effective rate of protection, which varies from an industry to another, would be on average about 47%.[8]

If the free-trade area is established, the phasing out of customs duties on imports from the E.U. countries will lead to a gradual elimination of the protection enjoyed by Lebanese industries. Apart from the cases in which the effective rates of protection due to the current tariffs are redundant (they seem to be non-existent in Lebanon) and the cases in which some existing industries can reorganize their production and survive without protection, the phasing out of customs duties will be accompanied by a decrease of the domestic production of some goods, perhaps to the point of extinction. As a result some domestic factors of production will become unemployed. Until they find alternative activities with, at least, an equal rate of return, the phasing out of customs duties by Lebanon will lead to a loss in its domestic production. This kind of loss is not taken into account in the standard economic literature on trade liberalization, on the assumption that the domestic factors of production which become unemployed, due to the competition of imports from other members of the free-trade area or the customs union, will find without delay alternative activities with rates of return that are, at least, equal to those of their previous activities. The new occupations will be found in the industries where the country possesses a comparative advantage and which will expand or will be created as a consequence of the liberalization of trade in the partner countries.

Such a phenomenon can hardly be encountered in the case at hand. Firsbecause the Lebanese industrial products have been enjoying a complete free access in the European countries since 1978. This free access cannot and will not be improved by the new agreement. Secondly, the Lebanese industrial sector is in

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[8] **The effective rate of protection gives the rate of increase in value added in comparison with the value added for the same output under free trade. If the price of a unit of a good is LL. 100 for example, and the price of intermediate goods is LL 51, then the value added (under trade protection) is LL 49. Since we assume that the rate of import duties is 20% on competing foreign goods and on intermediate goods the price of the good, under free trade, will be LL 83.3 = 100/(1+0.20) and the price of intermediate goods is LL 50.0 = 51/(1+0.02) The value added under free trade is LL.83.3 - LL 50 = LL 33.30. The effective rate of protection is then [(49 - 33.3)*100] / [33.3] = 47%.**

general not cost-effective. It is foremost oriented toward the domestic market and secondarily towards exporting to the neighboring Arab countries. Such a sector is not able to benefit effectively from the free access offered to it in the EU countries, to which its exports have been negligible. Unless and until an almost complete restructuring of the Lebanese industrial sector takes place, the liberalization of free trade with the EU is expected to cause a loss to the Lebanese economy.

The question is : In case the free-trade area is established, what is the loss to the Lebanese economy from a drop in domestic output? The answer to this question, is given in Table 9.

Table 9
Losses to the Lebanese Manufacturing Sector from the creation of a free-trade Area with the European Union.

Year	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	
Average rate of customs Duties(%)(1)	15.00	13.50	12.00	10.50	9.00	7.50	6.00	4.50	3.00	1.50	0.00	0.00
Scenario N_1 : Factors of production will remain unemployed for a period of one year												
Industrial production index (for domestic market)(2)	100	95.50	95.50	95.50	95.50	95.50	95.50	95.50	95.50	95.50	95.50	100
Value added loss(3) (in million of US$)		84	84	84	84	84	84	84	84	84	84	Zero
Permanent employment loss(4)		5031	5031	5031	5031	5031	5031	5031	5031	5031	5031	Zero
Seasonal employment loss(4)		1761	1761	1761	1761	1761	1761	1761	1761	1761	1761	Zero
Scenario N_2 : Factors of production will remain permanently unemployed												
Industrial production index (for domestic market(5)	100	95.50	91	86.50	82.00	77.50	73.00	68.50	64.00	59.50	55.00	55.0
Value added loss (5) (in million of US$)		84	168	252	336	420	504	588	672	756	840	840
Permanent employment loss(5)		5031	10062	15093	20124	25155	30186	35217	40248	45279	50310	5031
Seasonal employment loss (5)		1761	3522	5283	7044	8805	10566	12327	14088	15849	17610	1761

1- The average rates of customs duties used in this table are from table 1
2. The production index for the local market
3- Value added 1 losses were derived as follows : from the 1995 industry survey commissioned by the Ministry of Industry in Lebanon, the value of the industrial production reached $3719 million, in 1994 with exports for about $509 million; consequently, 3719 - 509 = $3210 million for the local market. The value added of this output is $ 1573 million (3210 x 49.10%), and we have assumed that the value added will grow at rate of 6% between 1995 and 1997. As a result the value added for 1997 is $ 1873 million (or $ 1573 x (1.06). In this case, the losses from the unemployment of resources for one year is $ 84 million (or 1873 x 4.5%) where 4.5 is the drop in the production index.
4- Employment losses were calculated using the 1995 industry survey which points to the fact that 59.7 permanent jobs and 20.9 temporary jobs produce a $1 million of value added.
5- Losses are calculated as in notes 3 and 4, but there is, in this case, an annual accumulation.

There is no loss when the factors of production in the industries whose output is reduced or eliminated can find, without delay, alternative activities with similar rates of return, which in our case is unlikely to happen. If we assume, however, that these factors need one year to find alternative activities, the loss from the successive and equal reductions (1.5% annually, as assumed in Table 1). will amount to 84 million dollars per year (in 1994 prices), with a loss of 5031 permanent jobs and 1761 seasonal jobs. This loss will remain unchanged and will disappear by the end of the year 2008. If, on the other hand, we assume that the period needed to find alternative activities is longer, there will be a greater loss; if it is two years, for instance, the loss in value added would be 84 x 2 = 168 million dollars per year.

Lastly, if each job lost in the industrial sector is not replaced, there will be an annual loss accumulation which will reach, from the year 2007 on, 84 x 10 = 840 million dollars per year in value added, with a loss of 50310 permanent jobs and 17610 seasonal jobs.

Which one of these scenarios is likely to materialize? In its present status, the Lebanese industrial sector, if deprived from protective tariffs, is generally unable to compete with industrial imports from the E.U. countries. In this case, the volume of its sales in the domestic market would, most probably, drop by 50%, from its present level as shown in Table 9.

It is, therefore, expected that the proposed free-trade area with the European Union would inflict a heavy loss on the Lebanese industrial sector unless the latter is able to attract adequate investments (possibly in cooperation and association with the E.U. business community) in order to rehabilitate itself and establish new industries. In this way, it will have the capacity to cope with foreign competition without protective tariffs, and its production will become mainly export-oriented, not only to Arab markets but also to those of the European Union. The renovated and new industries will then absorb the factors of production which were operating in the industries where output was reduced or eliminated. As we will see later, new and large scale industrial investments are essential to the success of the proposed free-trade area as far as Lebanon is concerned.

SECTION II

Potential Gains To Lebanon From The Proposed Free-Trade area with the European Union.

There are two sources of possible gain for a country joining a free-trade area : a rise in imports (called by economists "trade creation") and a rise in exports.

_1_. Gains from trade creation

When a country joins a free-trade area and reduces or eliminates its customs duties vis-‡-vis the member countries, its domestic prices will usually go down, leading to an increase in consumption and a decrease in production, and therefore to a rise in imports. This rise in imports represents for the country a gain which has two sources : first, the increase in domestic consumption; second, the replacement of domestic production with lower-cost imports.

We shall consider both sources of gain in the case of Lebanon.

a) Gains from the rise in consumption.

For a country joining a free-trade area, the rise in consumption due to the elimination of customs duties is considered, in theoretical and empirical studies, as a major source of gain. In general, the underlying assumption is that the eliminated duties would not be replaced by other taxes or, at least, not by taxes on imports. But the structure of the Lebanese economy, as we have seen, will compel the authorities to compensate any reduction in customs duties with an equal domestic tax which will be levied mainly on imports. As a result, domestic prices will remain unchanged and there will be no rise in consumption. Thus, there is no expected gain to Lebanon from this source.

b) Gains from replacing domestic production with lower-cost imports.

In general, the underlying assumption is that the factors of production idled by increasing competition from other member countries, find alternative activities with rates of return equal, at least, to those of lost activities. But this assumption, as we have seen, may not apply to Lebanon.

These gains, however, are not significant compared to potential losses from the drop in production. If we assume that the average rate of customs duties in Lebanon is 15%, the potential gain from replacing high-cost domestic production with imports from the E.U. countries would be, if the idled factors of production do not find alternative activities, one fourteenth of the potential loss from that replacement.[9]

[9] **For the proof, see appendix 2.**

Thus, we find that the gains from increased imports due to trade creation (considered as the main source of gain to a country joining a free-trade area) would be nil in the case of Lewhen the increase in imports is due to a rise in domestic consumption, and negligible when it is due to the replacement of high- cost domestic production with lower-cost imports from the E.U. countries.

2 - Gains from increased exports.

Lebanon is a developing country where GDP per capita is about 2500 US dollars, and where exports per capita did not exceed (according to official customs statistics) 200 US dollars in 1994. In contrast, we find in some small developed countries, like Sweden, Denmark and Switzerland, that the GDP per capita ranges between 26000 and 36000 US dollars (10 to 15 times that of Lebanon) and that the exports per capita range between 7000 and 12000 US dollars (35 to 60 times that of Lebanon). This comparison suggests that the growth of the Lebanese economy will depend, to a large extent, on the ability of Lebanon to increase its exports in general, and its industrial exports in particular. To the extent it contributes to that end, the free-trade area membership will be beneficial to Lebanon. As we have seen, the main characteristic of the proposed free-trade area is that it will take place between widely different economic entities. Lebanon is a very small country, with a GNP estimated at 8-12 billion dollars, whereas the combined GNP of the E.U. countries is about 8000 billion dollars -one thousand times that of Lebanon. Therefore, the demand of the E.U. countries on Lebanese exports would be perfectly elastic, which means that Lebanon can export to these countries, at their own price level, any quantity of any product. Thus, if Lebanon does not join the free-trade area, Lebanese exporters will have to bear the burden of customs duties levied by the E.U. countries. But if Lebanon becomes a member, Lebanese exporters will be those who benefit from tariff exemptions. In other words, the gain to Lebanon from joining the free-trade area would be proportionate to the level of the E.U. customs duties.

Due to successive reductions resulting from the GATT trade negotiations, the E.U. customs duties have reached a very low level, with an average rate of 4.30% at the end of 1994; under the recent agreements of the Uruguay Round, this rate will fall gradually to 2.67% by the year 2000. As to the customs duties on industrial goods (the most relevant to the Lebanese economy), their average rate will fall to 3.90% in 2000 from 6.50% in 1994. Consequently, the gain to Lebanon from joining the free-trade area would not be significant in terms of saved customs duties.

But if this kind of benefit is limited, the one that Lebanon could derive from the increase of the volume of its exports to the E.U. countries is practically unlimited because, as we said earlier, the perfect elasticity of the E.U. countries demand on Lebanese products.

Since 1978, Lebanon is enjoying the same tariff exemptions that are included in the proposed free-trade area agreement. Nevertheless, the value of Lebanese exports to the E.U. countries is almost negligible. In 1994, it did not exceed 86 million dollars, of which about 25% were in fact re-export of goods originating in the E.U. countries, such as aircraft engines. The reason is that Lebanese industrial production, with few exceptions, has developed to sell first in the domestic market where it enjoys a tariff protection, and second to export to neighboring Arab countries, where it benefits from the advantages stemming from geographical proximity and common language and culture.

In order to benefit from the proposed free-trade area, Lebanon has to make fundamental changes in the structure of its production, namely in the industrial sector. Beside the rehabilitation of existing industries, new industries have to be established, probably in collaboration and association with the business community of the E.U. countries. The main purpose of this restructuring would be to increase exports to the E.U. countries, the Middle East countries, and the rest of the world.

It is obvious, therefore, that Lebanon would benefit from the E.U. free-trade area to the extent that its industrial sector will be able to attract new investments. To this end, a number of conditions should be met, including security, public sector efficiency, adequate judicial process, modern infrastructure, and export-promoting policies. So far, the Lebanese trade policy has been restricted to the protection of domestic production through customs duties which, although moderate, increase the cost of competing imports. In order to be able to export and, therefore, to attract new investments to build export capacity, the Lebanese industry needs a completely new official policy, which would aim at reducing the cost of domestic production instead of increasing import prices.

Thus, the gains to Lebanon from the increase in exports are possible, but not certain; they could remain negligible, but could also reach very high levels. In fact, everything would depend on the ability of the Lebanese industry to attract new investments, and on the policies followed by the Lebanese authorities.

What is the minimum increase to be achieved in Lebanese exports to the E.U. countries in order to strike a balance between the gains and losses to the Lebanese economy from joining the free-trade area ? And what is the amount of new investments needed to produce that increase in exports ? To answer both questions, we shall first review the estimated losses to the Lebanese economy, as shown in Table 10.

Table 10
Estimated Total Loss to the Lebanese Economy from the Free-Trade Area
(in million of current US$, unless otherwise/specified)

	Losses from trade diversion (both scenarios deal with cases where Lebanon lowers import duties on...)		Losses from the drop in domestic output(1)	Gains from the switch to lower-cost imports(2)	Net losses to domestic output (both scenarios deal with cases where Lebanon lowers import duties on...)		Domestic Output(3)	Net losses in % of total output	
	First scenario Imports from E.U.	Second scenario All imports			First Scenario Imports from E.U.	Second Scenario All imports		First scenario	Second scenario
								(5) : (7)	(6) : (7)
Year	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1998	-5	zero	-104	7	-102	-97	14895	0.68%	0.65%
1999	-23	zero	-217	15	-225	-202	16717	1.35%	1.21%
2000	-65	zero	-338	24	-370	-314	18770	1.97%	1.67%
2001	-108	zero	-468	33	-543	-435	21060	2.58%	2.07%
2002	-179	zero	-609	44	-744	-565	23666	3.14%	2.39%
2003	-278	zero	-760	54	-984	-706	26324	3.74%	2.68%
2004	-412	zero	-921	66	-1267	-855	29280	4.33%	2.92%
2005	-555	zero	-1095	78	-1572	-1017	32584	4.82%	3.12%
2006	-759	zero	-1281	91	-1949	-1190	35912	5.43%	3.31%
2007	-1013	zero	-1480	106	-2389	-1374	39582	6.04%	3.47%

Notes :

1- The values in column(3) have been derived from scenario N_2,. line 2 for value added losses, in table 9, where the figures of valu added losses are in 1994 constant dollars. To obtain the values in column(3) we converted the value added losses in 1994 constan dollars into values in current dollars, assuming that international prices in dollars would increase by 4% annually during the perio between 1995 and 2007; as in the assumption used in the year 2000 Plan by the CDR.

2- In column (4) we used the same methodology, described above, to convert a $6 million gain in 1994 constant dollars into its curren dollar values for the period in question.

3- The source for this information is the CDR plan for reconstruction.

Table 10 is based on the assumption that the factors of production that are idled in industries whose output decreases after each reduction in customs duties or which go out of business will stay unemployed. We believe that this assumption would be the closest to reality. For, if the Lebanese industrial sector does not change and attract export-oriented investments, it is almost sure that those idled factors of production will not find alternative activities, at least in the industrial sector. Table 10 shows also the estimated losses to the Lebanese economy under two different scenarios : first, customs duties are reduced only for the E.U. countries; second, they are reduced and in the same proportion for all other countries. Under the first scenario, the loss would be larger than under the second scenario, because it includes the loss from trade diversion, which does not exist under the second scenario.

Table 10 shows also that if Lebanese exports to the E.U. countries remain as weak as they are, the free-trade area will inflict on Lebanon a heavy loss that could be hardly afforded. This loss would increase rapidly after each reduction in customs duties until it reaches about 6% of its GDP under the first scenario (removal of customs duties for the E.U. countries only) and about 3.5% of its GDP under the second scenario(removal of customs duties for all countries).

We now come to both questions we previously raised, trying to find an answer in Table 11.

Table 11
Estimated Necessary Changes in Industrial Exports and Investments to compensate for Losses from the Free-Trade Area
(in million of current US$)

Year	**Needed increase in exports to compensate loss(1)**		**Additional net investments needed to increase industrial exports(2)**	
	First scenario: Tariff reductions for the E.U. countries only	**Second scenario :** Tariff reductions for all countries	**First scenario:** Tariff reductions for the E.U. countries only	**Second scenario :** Tariff reductions for all countries
	(1)	(2)	(3)	(4)
1998	208	198	408	388
1999	459	412	492	420
2000	755	641	580	448
2001	1108	888	692	484
2002	1518	1153	804	520
2003	2008	1441	960	564
2004	2586	1745	1132	596
2005	3208	2076	1220	648
2006	3978	2429	1508	692
2007	4876	2804	1760	736

Notes :
1 - The figures in columns (1) and (2) are respectively derived from columns (5) and (6), in Table 10, on the assumption that the value added for manufactured goods in Lebanon is about 49% of output value, according to the above -mentioned Industrial survey by the Ministry of Industry..
2 - The figures in columns (3) and (4) are respectively derived from columns (5) and (6), in Table 10 by multiplying the annual changes in columns (5) and (6) by 4, which is the incremental capital-output ratio (ICOR) ,as used in the Year 2000 Plan for reconstruction and development of Lebanon.

Table 11 shows that, in order for Lebanon to avoid losses from joining the free-trade area, its industrial exports to the E.U. countries should rise fast enough to reach, by the year 2007, about 5000 million dollars if customs duties are reduced only on imports from the E.U. countries, and about 2800 million dollars if customs duties are reduced simultaneously on imports from all countries of the world. Table 11 also shows that additional investments in the Lebanese industrial sector should reach, by the year 2007, 1800 million dollars under the first scenario and 736 million dollars under the second. Unless these targets are achieved on time, the proposed free-trade area would have a very negative impact on the industrial sector, and thus on the whole Lebanese economy. But if the protocol on the rules of origin is adopted as it is proposed, it would be very difficult, if not impossible, to reach those targets.

SECTION III

The Protocol on The Rules of Origin

From the viewpoint of Lebanon's interests, the proposed protocol includes two important issues : (a) the rules of origin, and (b) Article 14, which prohibits the refunding of customs duties, and does not permit for their suspension.

a - Rules of origin

In any agreement on tariff exemptions or reductions, goods exported by a member country are not considered as part of its production and thus are not entitled to benefit from preferential treatment in the importing member country unless they meet some specific conditions, called the rules of origin.

A good usually goes through a number of production processes or stages. Each stage introduces a physical transformation on the product and adds to its market value. Hence the expression "value-added".

Sometimes, all the processing operations take place in the exporting country; in this case the good is considered as wholly produced by the country in question, and the resulting domestic value added is equal to 100% of the price.

In most cases, however, the various processing operations take place in a number of countries, and the domestic value added generated in the exporting country would be a certain percentage of the price (for instance 30%). What conditions should then be met for the product to be considered as originating in the exporting country ? This is determined by the rules of origin. These rules are based, often implicitly, on the value added or on the degree of processing criterion or on a combination of both criteria.

In its proposal, the European Union has not established a general rule of origin to be applied to all commodities, but rather a great number of rules to be applied to different commodities or different groups of commodities. The list of rules covers 111 pages; some are based on the concept of value added or on the concept of the degree of processing and some others on a combination of both.

A detailed survey of the rules of origin proposed by the European Union is beyond the scope of this study. We shall, therefore, restrict ourselves to the following remarks :

1 - In some instances, the rules of origin require that a commodity be wholly produced by the exporting country. But in most cases, partial transformation is accepted.

2 - When implicitly based on the value-added criterion, the rules require, in some instances, that intermediate goods be wholly produced by the exporting country, as in the case of corn oil, sunflower oil and sea-food products, which must be produced respectively from seeds and fish produced in the exporting

country. In other instances, intermediate goods could be imported, as in the case of soybean oil, peanut oil, and palm oil. In other instances also, the rules require that the value of imported intermediate goods must not exceed a specific proportion of the commodity price, which varies from a commodity to another.

3 - When based on the degree-of-processing criterion, the rules of origin rely on customs tariff classification to determine if the degree of processing is sufficient for the specification of origin. In some instances, a change from a tariff item to another is sufficient, as in the case of cocoa products; in other instances, the degree of processing should result in a double tariffs classification change. For example, meat products must be produced with live animals, which could be imported; if they are produced with imported meat, they are not considered as a product originating in the exporting country. Another example is the requirement that crochet-women knitwear must be produced with textile fibers and not with imported threads, and that men's garment must be produced with threads and not with textiles. Lastly, in some instances, the processing of a commodity is considered as sufficient, even if there is no classification change from a tariff item to another, as in the case of roasted or ground coffee, and the case of tea even though aromatic.

4 - In many other cases, a combined criterion is used, based on value added and the degree of processing. In addition to changes in tariffs classification as a result of processing, the rules require that the price of imported intermediate goods do not exceed a given proportion of the exported commodity price, and this proportion varies from a commodity to another.

As proposed, the rules of origin are actually tailored to the interests of the productive sectors in the E.U. countries. Most probably, they create, now and in the future, a real obstacle to the growth of Lebanese exports to the E.U. countries, and thus limit to a great extent the potential gains to Lebanon from joining the free -trade area .

In our view, the proposed rules should be carefully and extensively analyzed in consultation with the Lebanese industrial and expert community, in order to know what is acceptable and what should be proposed for amendment. Actually, it is in the interest of Lebanon to adopt a general and simple rule of origin, which would for instance rea ceiling on the share of the domestic value added (say, 60%) in the exported good price, or a ceiling on the share of imported intermediate goods (say, 40%). Alternatively, the rule of origin could require that the processing operation should result in a single tariffs classification change from one item to another. This is because the Lebanese industry depends heavily, and most probably will continue to depend on the imported raw materials and intermediate goods. Any obstacle to these imports is not in the interest of the country.

b - The reimbursement of customs duties and their suspension.

According to Article 14 of the proposed protocol, Lebanese exports which are manufactured with imported intermediate goods on which import duties have been reimbursed, or with intermediate goods which have benefited from a tariff - suspension status (free areas, industrial warehouse, temporary entry, etc.) do not benefit from tariff exemptions under the free-trade area agreement, even if they meet all other requirements of the rules of origin. But, the provisions of article 14 do not apply to agricultural products: import duties paid on intermediate goods can be reimbursed, because this is consistent with the interests of agriculture in the E.U. countries.

The prohibitive provisions of Article 14 would partly, and most often totally, eliminate the benefits to the Lebanese industry from the proposed free-trade area.

Since tariff rates are, in the E.U. countries, at a low level (an average of 6,50% on industrial goods which will be reduced to 3.9% by the year 2000), the imposition by Lebanon of customs duties on intermediate goods may raise the cost of its industrial production by an amount exceeding the value of exemptions granted by the European Union. The only way to overcome this obstacle would be for the Lebanese industry to use the cumulative origin rule, that is to import the needed intermediate goods from the European Union itself, and in so doing to circumvent the provisions of Article 14. This solution, however, is not always possible and appropriate, because : (1) the needed intermediate goods may not be a E.U. produce; and (2) the double freight cost from the European Union to Lebanon (as an intermediate good) and then from Lebanon to the European Union (as an end-product) could make Lebanese industrial exports uncompetitive on the E.U. markets, and therefore deprive in fact Lebanon from the benefits of the free trade area.

There is no justification to the provisions of Article 14, in addition to the requirements of the rules of origin. Customs duties per se are levied only on goods to be consumed within a country. The reimbursement of duties levied on re-exported goods, and the duty-suspension status applied to temporary imports of intermediate goods are very common systems; and both are used all over the world, including the E.U. countries. The proposed Article 14, in addition to the restrictive rules of origin, has no purpose but to limit the Lebanese export capacity to the E.U. countries. Eventually, the provisions of Article 14 and the rules or origin could wipe all the benefits from the proposed association agreement. The end result from this association would be a net loss for Lebanon.

As we said earlier, Lebanon has to examine carefully and extensively the rules of origin specified for each industry, in order to take a stand in negotiations. But the provisions of Article 14 should be utterly rejected. In case the European party insists on Article 14 and Lebanon decides, nevertheless, to accept the association agreement, the negative impact of Article 14 could be avoided by an immediate elimination of customs duties on all raw materials and intermediate goods that are needed for Lebanese industrial production.

We turn now to the last point in this paper —the impact on regional economic cooperation and integration of the free trade areas between the EU and the Mediterranean countries.

SECTION IV

The Impact of the EU-Mediterranean Countries' Free Trade Areas on Regional Economic Cooperation and Integration.

If the success of the free trade area between the EU and Lebanon is conditional, from the Lebanese interests point of view, on the ability of Lebanon to restructure its economy in order to make it more cost-effective and export-oriented, we take it for granted that Lebanon will gain from regional cooperation and integration. The Lebanese economy is very small; therefore, exporting is a necessary condition for the Lebanese industry to benefit from economies of scale and become competitive. And as usual, the region is the area where the Lebanese products, because of proximity and the common language, are offered the best conditions to compete. The same applies to the other countries of the region.

The question we ask is what is the expected impact on regional economic cooperation and integration of the free trade areas between the EU on the one side and Lebanon and the rest of the Mediterranean countries concerned on the other side? The answer in this section will be brief and based on considerations of a general nature.

We must note, first, that the free trade areas already in existence or which will be created have or will have a bilateral character. They take place strictly between the EU and each of the Mediterranean countries separately. Hence, a Lebanese industrial product, for example, may have a free access in the EU countries, but will have to be submitted to customs duties and other barriers to trade whenever they exist, if it is exported to any country of the region. The same does apply if the product is exported by Tunisia or Morocco, etc. True, the association agreements, signed or to be signed between the EU and the Mediterranean countries, particularly articles 1, 23 and 54, stipulate that the agreement aims at promoting intra-regional trade, and that they will not preclude the maintenance or the establishment of regional free trade areas or customs unions. Such provisions can however be considered as being a sort of a wish or declaration of intention. Furthermore, the agreements do not contain any concrete measures which would promote effectively regional economic cooperation and integration.

All the attempts made so far since the fifties by the Arab countries, whether including all or restricted to a sub-region or to a few of them, have ended in an almost complete failure. The last attempt being the decision taken at the Arab league level in February 1997 to create a free trade area between all the member countries in a ten year transitional period beginning in early 1998. There is no indication that this new attempt will not have the same fate as the previous ones.

The reasons for the failure have been analyzed extensively in the economic literature. They are varied and include 1) the lack of political will on the part of the member countries, strong enough to surmount the difficulties existing in the way of economic integration; 2) lack of sufficient direct means of transportation and communication between the countries of the region; 3)incompatibility between the economic systems of the member countries, and so on.

The bilateral free trade areas between the EU and each of the Mediterranean countries will have three positive effects on regional economic cooperation and integration. The first effect relates to the fear of competition. The experience has shown that the Arab countries, like most of the developing countries, are afraid of exposing their domestic production, particularly their industries, to foreign competition, whether from Arab countries or from the rest of the world. Having been built mainly to meet local demand, the domestic industries are in general cost-inefficient and they operate under high protection. A foreign, free competition will likely wipe them out. This will hurt the vested interests and will aggravate unemployment, which is very often high.

A successful implementation of the free trade areas between a Mediterranean country, i.e. Lebanon, and the EU presupposes that Lebanon has managed to restructure its industrial sector andto make it, as we have seen, cost-effective and export-oriented. If Lebanon manages to make its industries capable of facing competition from the EU countries, Lebanon will certainly not be afraid of exposing its industrial sector to competition from the countries of the region.

The second effect concerns the costs from trade diversion. When two or more Arab countries engage in a trade liberalization scheme, they will incur high trade diversion costs for mainly two reasons:

_1_) The level of protection from tariffs and other barriers to trade are usually high in most of the countries of the region;

_2_) Import prices from the partner countries in the regional scheme are generally much higher than import prices from the efficient sources of supply in the rest of the world.

In turn, the high trade diversion costs render the regional integration scheme less attractive to potential member countries.

Let us suppose that along with the free trade area with the EU, a country like Lebanon enters in a regional free trade area agreement. In such a case, exporters of the regional partner countries will have to compete in the Lebanese market with exporters, generally cost-effective, from the EU. Import prices in Lebanon from the region cannot exceed import prices of similar products from the EU. As a consequence, trade diversion costs from the regional arrangement will be in very many cases nullified or at least substantially reduced.

The third and last effect of the free trade areas with the EU on regional economic cooperation and integration relates to domestic investments, the increase of which is very much needed almost by all countries of the region.

With the bilateral free trade areas arrangements, the EU exports will have free access in all its Mediterranean partner countries, while products from a Mediterranean country will be subject to normal tariffs and other barriers to trade if exported to any other country in the region. This situation will be reversed if in addition the countries of the region also conclude a free trade arrangement. By so doing, they will enhance, hopefully in a substantial way, their respective opportunities to attract new investments.

In conclusion, we can say that the free trade areas between the EU and the Mediterranean countries will facilitate the creation of schemes of regional economic cooperation.

SECTION V

Summary and Conclusions

A -Summary:

The new trade agreement proposed to Lebanon by the European Union is based on the principle of reciprocity, in the sense that Lebanon will have to grant E.U. commodities, although gradually, the same exemptions which are granted to Lebanese products by the European Union. From this viewpoint, it represents a backward step because, under the 1978 agreement, Lebanese industrial products enjoy, with no counterpart, unrestricted access to the E.U. markets. Moreover, the E.U. is appending to the proposed agreement a protocol on the rules of origin, which are tailored to the industrial needs of the E.U. countries. If accepted, some of them will be real obstacles to the growth of Lebanese exports to the E.U. markets.

The question is, therefore : should Lebanon accept the proposed new free-trade area agreement, and the protocol on the rules of origin? If so, what would be the proper conditions ?

In an attempt to answer this question we have examined the potential losses and gains to Lebanon from joining the free-trade area,. In the last part, and discussed the rules of origin as proposed by the E.U.

_1_. Potential losses

Three factors were examined under this heading :

1) __Loss of import duties__ : In itself, this is not a loss to the Lebanese economy. But rather it is a financial loss (although expected to be high) which must be compensated by new domestic taxes (such as the value-added tax) on domestic products and imports, but not on exports. Lebanese imports would be then the main target of such taxes, and the tax rates should be approximately equal to the reductions in customs duties. As a consequence, domestic prices would remain unaffected by the free-trade area.

2) __Losses from trade diversion__ : The preferential treatment to be granted by Lebanon to the E.U. products would result in replacing a great number of Lebanese imports from the world markets with higher-cost imports from the E.U. countries. This diversion of imports would result in a loss to the Lebanese economy; which loss is expected to increase after each tariff reduction by Lebanon in favor of the E.U. countries, reaching a very high level at the end of the transitional period when full exemption will be granted to imports from the E.U. countries. Under a number of assumptions we have estimated that the losses would amount to about one billion US Dollars in 1994 prices, using the findings of the Model on the Lebanese economy adopted by the C.D.R.

If, as it is likely to happen, the Lebanese negotiators cannot obtain from the European Union a full compensation for the loss from trade diversion (given that the loss to Lebanon is a gain to the E.U. countries) Lebanon could resort to a simultaneous and equally gradual elimination of customs duties on imports from the rest of the world. Then, regardless of their origin, all Lebanese imports would receive the same preferential treatment, and there would be no trade diversion and, therefore, no loss to Lebanon.

3) __Losses from a decreasing or vanishing domestic production__ : This loss is not usually taken into account in theoretical or empirical studies on free-trade areas, which assume that the idled factors of production will find without delay alternative activities with rates of return that are, at least, equal to those of their previous activities. But this assumption does not apply to Lebanon. While some Lebanese industries will suffer from a drop in production, others will go out of business due to increasing competition from the E.U. countries. And the idled factors of production will not be able to find alternative activities, at least in the industrial sector, if this sector remains in its present situation. This would result in an expectedly high loss, which we have estimated (on the basis used to estimate losses from trade diversion) at 840 million US Dollars in 1994 prices, together with a loss of more than 50.000 permanent jobs and about 18000 seasonal jobs.

2. <u>Potential Gain</u> :

We have examined in this study two possible sources of gain :

1) Gain from increased imports : This gain, called by economists "trade creation", is considered in economic theory as the main source of gain for a country from joining a free-trade area (or a customs union). But our study has shown that, in the case of Lebanon, this kind of gain would be negligible.

2) Gain from increased exports : Our study has shown that, in the case of Lebanon, this gain is probable, and could vary from a very small to a very large amount.

Although they benefit from exemptions under the 1978 agreement, Lebanese exports to the E.U. countries are presently very weak. In fact, Lebanese industrial production has mainly developed around meeting domestic demand in a protective environment, but also with a view to export mainly, and sometimes exclusively, to the neighboring Arab countries. In general, in terms of quality and prices, Lebanese industrial production is not exportable to the E.U. markets.

In order to benefit from the exemptions that are included in the new association agreement (basically identical to those of the 1978 Agreement), Lebanon needs new industrial investments, in order to produce for exportation. If, for this purpose, Lebanon succeeds in attracting adequate investments, its gains could be considerable. If not, they would remain negligible as they are now.

Moreover, the proposed rules of origin are another obstacle to achieving the desired increase in exports.

3. **Rules of origin** :

Our study has shown that the rules of origin, as proposed by the European Union, will hamper the growth of Lebanese exports to the E.U. countries. Actually, they are hidden instruments to protect the E.U. production. The Lebanese negotiators should, ther, give special attention to the following two elements :

First, according to Article 14 of the rules of origin, Lebanese exports which have benefited from a duty-reimbursement regime or from a duty-suspension status (free area, industrial warehouse, or temporary entry) cannot be duty-exempted in the E.U. countries, even if they meet all other conditions specified in the proposed protocol.

It is obvious that this Article cannot be accepted by Lebanon.

Second, The European Union is not proposing a general rule for all industrial products, but rather specific rules for each industry, based either on the value-added or the degree-of-processing criterion, or on both criteria. They are designed to serve the interests of the E.U. industries, and could obstruct external competition.

If the Lebanese negotiators cannot replace all the proposed rules with a single and general rule, based on the value-added or the degree-of-processing criterion, the proposed rules should be examined one by one, in order to know what could be accepted, rejected, or proposed for amendment.

B - Conclusion :

Where are ultimately the interests of Lebanon ? Is it to join the proposed free-trade area under the new association agreement with the European Union or to stay out of it ? The answer is not easy. On one hand, there would be for sure a significant loss stemming mainly from the drop in industrial output and, in some cases, from its extinction due to increasing competition from the E.U. countries. This implies that Lebanon would receive from the E.U. a compensation for the loss incurred through trade diversion, or that the loss would be avoided by a gradual elimination of customs duties on imports not only from the E.U. countries but also from the rest of the world. On the other hand, there could be a gain, although uncertain, ranging from a negligible to a high level, exceeding the possible loss. It would come mainly from an increase in exports, which cannot be achieved without attracting new large-scale investments to the industrial sector, perhaps in collaboration with investors from the E.U. countries. In so doing, Lebanon would secure modern technology and gain access to foreign markets. These investments, however, need an appropriate environment, including mainly stable conditions and policies conducive to the lowering of domestic production costs by international standards. Thus, without the needed investments and the increase in industrial exports, Lebanon would incur a big loss from joining the proposed free-trade area.

Eventually, if accepted by Lebanon, the free trade agreement will prop the industrial sector (and probably, in the future, the agricultural and services sectors) to work gradually and then completely (at the end of the transitional period) in a duty-free environment with no tariff protection. This, in itself, is not inconsistent with Lebanese interests. On the contrary, Lebanon needs to restructure its economy, namely the industrial sector, in order to have greater access to foreign markets in general, and to the E.U. markets in particular. Accordingly, there is no contradiction in the long run, between the interests of Lebanon and the trade liberalization scheme proposed by the European Union. The problem for Lebanon is how to enable its industrial sector to make, without economic and social troubles, a transition from working under protection to working in free trade conditions. The solution to this problem should be found during the transitional period, which is unilaterally set at 12 years by the European Union and which should end by the year 2010, as decided in the Barcelona Conference (27 - 28 November 1995). This solution does not depend only on the negotiation team but also and mainly on the Lebanese authorities. The problem for Lebanon is not only to obtain better conditions from the E.U. but also to design and implement appropriate domestic economic policies.

In sum, we think it is in the interests of Lebanon to accept the proposed free-trade agreement, but with the following conditions :

1 - To link each reduction in Lebanese tariffs to the achievement of a specific increase (to be determined by negotiations) in Lebanese exports to the European Union, so that Lebanon would not initiate the tariff reduction process or go to a further stage before reaching the negotiated specific level of export increase. In case this condition is not accepted by the European Union, tariff reduction by Lebanon and, consequently, the 12-year transitional period should not start before, say, a period of five years during which Lebanon would rehabilitate its infrastructure, and meet all economic and other conditions. If not, it would be very difficult for Lebanon to attract additional investments, and avoid losses, and economic and social troubles, that could result from joining the proposed free-trade area.

2 - In order to avoid the loss from trade diversion, Lebanon should, at each phase of the transitional period, reduce simultaneously and in the same proportion its customs duties on imports from the E.U. countries and those from the rest of the world if Lebanon, as expected, cannot get an adequate compensation from the European Union.

3 - Regarding the proposed protocol on the rules of origin, Lebanon should utterly reject Article 14, which rejects the E.U. tariff exemptions on Lebanese industrial exports if the raw materials or intermediate goods used in their manufacturing have benefited in Lebanon from a tariff-suspension status (free area, industrial warehouse, etc.) or if the paid import duties have been reimbursed.

4 - The proposed rules of origin should be replaced with a single rule, based on the value-added or degree of processing criterion (a one-time tariff classification change). In case this condition is not accepted by the European Union, the Lebanese authorities should undertake, in collaboration with the industrial and expert communities, a detailed and extensive survey, in order to know the rules that could be accepted, rejected, or proposed for amendment.

The Lebanese public and private sector authorities should be convinced that the future of the Lebanese industry does not depend on its protection in the domestic market, which is very small, but rather on lowering its production costs. Appropriate policies and procedures should, therefore, be put in place without delay, in order to modernize the industrial sector and make it export-oriented. Lebanon would then be able to benefit from joining the free-trade area proposed by the European Union.

Lastly, it is of prime importance to Lebanon to enter a regional free trade arrangement the conclusion of which will hopefully be facilitated by the association agreements between the EU and the Mediterranean countries.

APPENDIX I

Structure of the Lebanese Domestic Market for Industrial Products, by Country of Origin

First : The situation in 1994

	Value in million of US$	Share (%)
1. Lebanese Industrial Production (according to the 1995 Industrial Survey by the Ministry of Industry)	**3,71**	
Less:		
Industrial Exports(1)	50	
Industrial output sold in the domestic market	3,21	33.33%
2. Value of industrial imports	**5,41**	
Plus customs duties (15%)	6,23	
Plus 3% for clearance, transportation and storage	6,40	
Distributed almost evenly between the European Union and the rest of the world :	3,20	33.33%
• Imports from the E.U. Countries		
• Imports from the rest of the world	3,20	33.33%
	9,61	**100.00%**

(1)We based our calculation on the 1994 foreign trade statistics published by the Lebanese Customs Higher Council.

Second : Projected Structure of the Lebanese Market for Industrial Products after the creation of a Free-Trade Area with the European Union.

Assuming that, for every 1% reduction in import duties on European industrial products, the share of these goods in the Lebanese domestic market would rise by 2%, and since the average customs duties in Lebanon is 15%, the share of European industrial goods in the domestic market would reach by the end of thtransitional period about 63.33% (or 33.33 + 30).

If we assume that the increase in the E.U. share is, on an equal basis, to the detriment of the domestic industrial output and the industrial imports from the rest of the world, the 30% gain in market share for European products will translate into a 15% loss in the share of domestic output (33.33 - 15 = 18.33%), and a 15% loss in imports from the rest of the world (33.33 - 15 = 18.33%).

Consequently, Lebanese imports of European goods as a percent of total imports of industrial products will amount to about 78% (or 63.33/(18.33 + 63.33).

APPENDIX II

Note on the losses and gains to a small developing country from trade liberalization or from an integration scheme : a different view

In the standard analysis of the gains and losses to a country from trade liberalization and from a customs union or free trade area formation, two assumptions, usually kept implicit, are made which do not accord in general with facts in the developing countries, and in Lebanon in particular. The first assumption is related to the gain from the increased consumption supposed to result from the removal of tariffs; and the second to the gain from the replacement of domestic production by lower costs imports. The relaxation of the two assumptions in order to make the analysis closer to reality will show that trade liberalization or a free trade area (or the like) formation will bring to a small developing country lower gains and higher losses than those obtained in the standard analysis.

After a brief review of the standard analysis in Section I, we will discuss the relevance and analyze the consequences of the relaxation of the two assumptions in Sections II and III respectively. In Section IV, some aspects of trade diversion will be discussed, while section V will be devoted to the conclusion.

1. The standard analysis.

The standard analysis of trade liberalization is illustrated in figure I below. SS and DD represent respectively the supply and demand in a small developing country of a certain good which is supposed to be homogeneous. BB is the supply curve of the rest of the world, customs duty AB included; while AA is the same supply curve, customs duty excluded.

Figure I.

According to the standard analysis, the removal of the customs duty AB will bring the domestic price down from OB to OA. Domestic consumption will increase per unit of time by the quantity HG. Domestic production will decrease by JI. Imports will increase by HG + JI. The standard analysis concludes that the country will obtain a gain that has two components : a) a gain in consumers surplus represented by area FGH; and 2) a real cost saving from replacing domestic production by lower costs imports equal to area EIJ. This conclusion does rest, as we mentioned, on two assumptions which we will now discuss successively.

2. The assumption related to the gain from the increase in consumption.

When the standard analysis states that the removal of the customs duty AB will result in a decrease of the domestic price by that amount, it assumes that this duty will not be replaced by any other tax which will be levied on imports. This assumption will not be the least realistic in the case of a small developing country like Lebanon, where the share of tariffs revenues in the total fiscal receipts of the Central Government is around 55%. Because of the structure of its economy, Lebanon like most if not all the small developing countries, is not able to forego tariffs revenues. Nor will it be able, if tariffs are removed, to compensate them by new taxes on income or capital gains. The only feasible and practical way of compensation offered to the Lebanese authorities would be to impose new taxes, such as a value added tax, on domestic production as well as on imports. But, as a matter of fact, the new tax revenues are expected to be levied mainly, and in a proportion that can exceed 90%, on imports and only marginally on domestic production. On the one hand, because of the narrow base of this latter; and on the second hand, because the large majority of the domestic units of production are very small, which makes the collection of the new tax revenues from them a very difficult and costly task. Accordingly, the new tax rates will have to be equal or at least very close to the customs duties removed for compensation to be possible.

In figure 2 below, we suppose that the customs duty AB of figure 1 has been removed and has been replaced for fiscal reasons by a new tax, of an equal amount, which will be levied on imports as well as on domestic production. For this reason, the domestic supply curve shifts upwards by a distance equal to AB from SS to S'S'; while the supply curve of the rest of the world, including the new tax, remains the same at BB as it used to be with tariffs. Hence, domestic consumption remains also the same, at point F. As a consequence, the country does not reap from the removal of its tariffs any gain in consumers surplus, as the standard analysis predicts. We come now to the second assumption..

Figure 2

. **The assumption related to the gain from the substitution of domestic production by lower imports.**

In the situation illustrated in figure 2 (and also in figure 1), domestic production per unit of time decreases by the quantity KE equal to JI, which is replaced in consumption by lower costs imports. To say, as does the standard analysis, that a gain equal to the area EIJ accrues to the country from this replacement, is to assume that the factors of production made idle by the drop of the domestic production have readily found new employment with returns at least equal to the previous earnings they have lost and which are represented in both figures 1 and 2 by area EJQ_1Q_2.[10][1] More often than not, this assumption is also far from being realistic in small developing countries, including Lebanon, particularly as far as the industrial sector is concerned. The reason is that, with few exceptions, domestic production has been built and does operate under tariffs and other means of protection in order to sell mainly in the local market. If protection is lifted, many of the domestic firms will be wiped out of business, with no possibility for the small developing country to provide new jobs to the factors of production made unemployed. The loss to the country from the decrease of its production by the quantity JI per unit of time will then be equal to area EJQ_1Q_2. (1)

For this loss to be zero, as it is assumed in the standard analysis, the economy of the small developing country should be restructured and its existing production units be replaced by cost effective, mainly export-oriented activities. This restructuring, however, needs quite a long period of time to be implemented, and is unlikely to succeed without substantial investments as well as financial and technical assistance from the developed countries. Mean-while, the small developing country will bear from the removal of its protection a net loss equal in figure 2 to EJQ_1Q_2 - EJI = JQ_1Q_2I. This net loss, which could be considered of a transitional character, is, in many instances, quite heavy.

4. Trade diversion.

To the net loss mentioned in the previous section, we should add the loss from trade diversion, as accounted for in the standard analysis, in order to obtain the total cost to a country in case it joins an integration scheme. In this respect, it is worth noting that if the integration scheme is taking place between a large developed country or a group of developed countries and a small developing one, like the free

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[10] If the customs duty is 15%, $E_1=0.15JQ_1$. Accordingly, the area EJQ_1Q_2 divided by the area E_1J would give: $2.15/0.15 \neq 14$

(1)Let t = the ad valorem tariff rate
OA = P and $Q_1Q_2=Q$
The area EIJ = 0.5 (t P Q)
The area EJ Q_1Q_2 = 0.5(2P+tP) Q = 0.5 PQ (2+t)
Hence, EjQ_1Q_2 /EIJ = (2+t)/t . If t = 0.15 , then (2+t)/t = 14.34

trade area arrangement being at present negotiated between the European Union and Lebanon, the loss from trade diversion is expected to be heavy on the small developing country and almost nil on its developed partner, for at least two reasons :

I) The share of the large developed country in the small developing small country total imports is usually very high before the free trade agreement and will probably increase substantially soon after its conclusion. For , the European countries share in the Lebanese imports is now around 50% and may increase after the full implementation of the free trade area to more than 80%. The situation is quite the opposite on the other side. The share of the developing country in total imports of its large developed partner is almost nil, and will most probably remain so during many years after the implementation of the free trade arrangement.

ii) Customs duties are usually much higher in the developing than in the developed countries.

The impact of a free trade arrangement on the economy of a small developing country is illustrated in figure 3 below.

Figure 3

In this figure, AA and BB are the supply of the rest of the world, respectively excluding and including the customs duty AB. CC is the supply curve from the partner country in the free trade arrangement, which is supposed to be large and developed. BC is the new domestic tax (for example, a value added tax) the developing country has created to compensate the tariffs revenues loss caused by the free trade arrangement. To make our analysis simple, BC has been chosen so that it is equal to the difference between OB and OC. The supply curve of the rest of the world, including tariffs and the new domestic tax (not represented in figure 3) will shift above BB by a distance equal to BC.

As in the previous case illustrated in figure 2, consumption in the small developing country remains unchanged at point F. Consequently the country does not enjoy a gain from an increase in consumers surplus. On the other hand, production will decrease by LM which is replaced by lower costs imports from the developed member country. But as long as the small developing country fails in providing new activities to the factors of production rendered unemployed, the replacement of its production by imports will bring to it not a gain but a net loss which is equal to area LQ_1Q_2M in Figure 3. In addition, there is a loss to the country from trade diversion, equal to area IMPR. However, the small developing country can certainly avoid the trade diversion loss if it reduces its customs duties vis-‡-vis the rest of the world at the same rates and time it reduces them vis-‡-vis its partner countries in the integration scheme. In such a case, the situation of the developing country would be as illustrated in figure 2 .This solution, we should note, is not possible except if this scheme is of the free trade area type, where each member country keeps complete freedom in the determination of the levels of its external tariffs.

V - Conclusion

Because of its economic structure, a developing country, particularly if small like Lebanon, is not likely to enjoy a gain from trade liberalization or from an integration scheme with a large developed country or group of countries; rather and until its succeeds in restructuring its economy and creating new cost effective export-oriented activities, the small developing country will suffer a loss. This loss, which could be heavy and last for quite a long period of time, would explain at least partly, the reluctance and resistance of the developing countries to liberalize their trade, and should be taken into account in trade negotiations whether bilateral or multilateral.

APPENDIX III

Customs Duties in Lebanon

The new "Lebanese Customs Duties according to the Harmonized System", published by the Lebanese Customs Higher Council and effective from the beginning of 1996, include 5578 tariff items and sub-items distributed by duty rates, as shown in Table 1.

Table 1
Distribution of Lebanese Tariff Items and Sub-Items by relevant Tariff rates
(in percent of total number of new items)

Duties	zero	2	5	10	15	20	25	30%	35	40	50	80	100
Proportion of items taxed with each tariff rate	0.01	30.4	15.7	26.1	11.8	5.8	3.3	5.80	0.5	0.00	0.0	0.2	0.0
Cumulative proportion	0.01	30.4	46.1	72.2	84.0	89.8	93.1	98.91	99.4	99.4	99.4	99.6	99.7

Table 1 shows that :

1. About 99% of tariff items and sub-items are associated with rates not exceeding 30%.

2. These items can be divided almost equally in two categories :

- About 46% are taxed at a rate of less than 5% (in fact two third of this category are taxed at a rate of less than 2%).
- The remaining 53% are taxed at a rate between 10% and 30%.

3. If each tariff rate is weighted by the number of items or sub-items to which it is applied, the average tariff would be 10%.

4. This rate of 10%, the most frequent in Lebanese tariffs, is also the median rate.

It is to be noted that if we calculate the unweighted average of tariff rates in the first fifteen chapters (major categories), which include mainly live animals, meat products, vegetables and fruits and if each rate is weighted by the number of relevant tariff items, we obtain about 10.25%.

5. If we exclude the 2% and 5% rates that apply mainly to raw materials, intermediate goods, agricultural and industrial equipment and machines, and also on some foodstuffs considered as basic, the average tariff rate computed with the above-mentioned method, will be 15.98%. This rate reflects in our opinion, the average tariff rate on industrial products in Lebanon.

In the following table, the tariff average is calculated on the basis of customs duties collected on imports during the last four months of 1995.

Month	Total imports (in billion of LL)	Customs Duties (in billion of LL)	Average Tariff Rate (%)
September 1995	957.70	136	14.20
October 1995	1073.87	157	14.62
November 1995	890.32	141	15.84
December 1995	1032.17	157	15.21
TOTAL	3954.08	591	14.95

The average tariff rate for the last four months of 1995 as a whole is 14.95% or about 15%, which is the rate used in our study.

The question is now : what are the effective rates of protection to the domestic industry through customs duties ? The answer to this question requires information not available to us when undertaking this study. But in order to give an idea about effective protection in Lebanon, we have used some of the findings of the Industrial census published by the Ministry of Industry in December 1995, and have obtained the effective rates shown in Table 2.

Table 2
Approximate Rates of effective protection to selected Lebanese Industries

Industries	The average effective rate of trade division
Processed vegetables	**46%**
Soaps and detergents	**50%**
Clothing	**48%**
Metal Capsules, and caps	**28%**
Aluminum products	**40%**
Leather tanning	**48%**

The weak point in these figures is mainly that they are based on sectorial ratios of the value of intermediate goods to the value of the final goods in order to derive the effective rates of protection for specific industries. Therefore, these figures should be used with caution.

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