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Sustainability Impact Assessment in Support of the Association Agreement Negotiations between the European Union and Mercosur

Executive Summary • December 2020



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Executive Summary

The trade relations between the EU and Mercosur are essential for both blocs, given that the EU is the second trading partner for Mercosur and Mercosur the eleventh trading partner for the EU. An inter-regional Framework Cooperation Agreement from 1999 currently forms the basis for EU-Mercosur trade relations. Following negotiations since 2000, in June 2019 the EU and Mercosur reached a political agreement for an Association Agreement including a trade component.

This Sustainability Impact Assessment (SIA) provides an examination of the potential economic, social, human rights and environmental impact of the trade component of an Association Agreement between the EU and Mercosur, specifically Argentina, Brazil, Paraguay and Uruguay. This analysis lays the basis for designing flanking and mitigating measures, a number of which are proposed throughout the study.

The report employs the dynamic version of the GTAP Model known as GDyn to study the impacts of two scenarios, one conservative and one more ambitious, with respect to the outcome of the negotiations in terms of tariff and non-tariff measures reductions by both parties. For Mercosur, the conservative scenario assumes the elimination of tariffs in 90% of the industrial products and 80% in agricultural products. In the ambitious scenario, Mercosur eliminates tariffs in 100% of products. The EU eliminates tariffs in all industrial products in both scenarios, applies partial tariff cuts of 15% in the conservative scenario and 30% in the ambitious scenario in rice, sugar, ruminant meat and other meat sectors. For the cereals and the dairy sector, cuts of 15% are applied in the conservative scenario and cuts of 100% in the ambitious scenario.

Quantitative methods are then combined with qualitative approaches to address social, environmental and human rights impacts of the free trade agreement as well as the specific economic impacts on ten important sectors.¹ This qualitative analysis draws on extensive consultation with stakeholders in both regions through workshops, civil society dialogues, questionnaires and interviews.

In the conservative scenario, GDP in the EU expands by 10.9 billion Euros (0.1%) and in Mercosur by 7.4 billion Euros (0.3%) by 2032, in comparison to the modelling baseline without the FTA. In the ambitious scenario, GDP in the EU expands by 15 billion Euros (0.1%) and in Mercosur by 11.4 billion Euros.

EU total exports to the world (extra-EU) expand by 0.4% in the conservative scenario and by 0.6% in the ambitious scenario. In Mercosur, total exports to the world expand between 0.5% in Paraguay and 4.5% in Brazil in the conservative scenario and between 0.7% in Uruguay and 6.1% in Brazil in the ambitious scenario. EU imports increase by 0.9% (1.1% in the ambitious scenario). In Mercosur, imports expand between 0.1% in Paraguay and 1.3% in Brazil in the conservative scenario and between 0.0% in Paraguay and 1.4% in Brazil in the ambitious scenario.

The modelling results provide also some valuable insights for the social analysis. In the conservative scenario, the agreement reduces consumer prices in Mercosur between 0.4% in Paraguay and 1.5% in Brazil (between 0.5% and 2.1% in the ambitious scenario in the same

¹ The sectors for in-depth analysis were selected in consultation with the EC.

countries). In the EU, they increase by 0.2% (0.3% in the ambitious scenario). Real wages for both skilled and unskilled workers in Mercosur increase slightly in the EU, Argentina, Paraguay and Uruguay and remain the same in Brazil. The increase in real wages for unskilled workers' income suggests a positive impact in terms of poverty reduction, although its effect is small in the conservative scenario and only marginally larger in the ambitious scenario.

Employment reductions in certain manufacturing sectors in Mercosur are offset by increases in the agriculture and food production sectors. The impact on the EU sectoral employment patterns is much less significant.

Labour standards in Mercosur are, in general, in line with those observed in countries at a similar level of development. There are higher levels of informality, which is a product of poor enforcement of and compliance with national legislation that tends to follow international conventions. The chapter about social aspects examines freedom of association, forced labour, child labour and discrimination in the EU and Mercosur countries and assesses the potential impact of the Agreement on these issues. The trade and sustainable development (TSD) chapter of the Agreement brings an opportunity to engage and cooperate between both parties to help to lock in or help renew the social achievements of the twenty-first century in the Mercosur region. The SIA includes a discussion of the value-added of EU policies on trade and labour linkage and their efficacy.

The environmental chapter addresses issues such as environmental regulations, greenhouse gases, deforestation and pollution. Environmental policies in Mercosur (like in many other developing regions) are, in general, less stringent than in the EU. Yet, Mercosur's current share of global greenhouse gas emissions is a third of the EU's, in large part because Mercosur countries have on average a cleaner energy mix than EU countries. Brazil and Paraguay have lower per capita emissions than the EU, whereas Argentina and Uruguay's emissions per capita are about the same as the EU's.

The quantitative analysis presented in the report predicts diversion of emissions resulting from diversion of production. The overall result is a small decrease in global CO₂ emissions offset by a small increase in emissions of other greenhouse gases. Emissions intensity of economic activity decreases marginally for the world economy as a whole, i.e. world economies produce less greenhouse gas emissions for a given amount of GDP, with a small increase in emissions intensity in Mercosur offset by a small decrease in the EU.

The expansion of animal production (associated with beef production), sugar cane production and other agricultural products in Mercosur seen in the model is small. Consequently, the analysis does not anticipate an increase in the use and contamination of water or an intensification of the use of pesticides.

For the same reason, no significant expansion of the agricultural frontier would be expected as a result of the Agreement according to the modelling results. This seems realistic especially when we look at past and current productivity trends. Deforestation in Brazil has been on the increase since 2012 having previously declined very sharply in the period 2004-2012, while meat production continued to increase. This period 2004-2012 demonstrates that it is possible to increase agricultural and meat production without increasing pressure on forests. But such a positive outcome will be dependent on the choice of flanking policies as set out in the environmental chapter.

The human rights chapter assesses the likely impacts of the free trade agreement on human rights. It covers in detail the right to an adequate standard of living, the right to the enjoyment of the highest attainable standard of physical and mental health, the rights of indigenous people and gender equality. The moderate increases in GDP, income and consumption that the agreement generates in Mercosur in both scenarios can contribute to improving standards of living. The limited increase in agricultural production is not expected to impact indigenous rights substantially and it is not expected to raise further conflicts. Nevertheless, this situation and the consequent risks should be monitored carefully following the implementation of the agreement. For the same and additional reasons, the agreement will bring limited benefits to the female workforce in rural areas. However, it may bring benefits to women in urban areas by expanding their participation in the labour force, especially the workforce allocated to the service sector.

The sectoral chapter builds on the modelling results while also drawing on other sources to provide a more in-depth analysis of the impacts on ten important sectors:

- In the beef sector, EU imports from Mercosur will increase in both scenarios (30% and 64%, respectively). EU output will fall by 0.7% (conservative) and 1.2% (ambitious). The sectoral analysis examines the expected impact in the beef sector in more detail, taking account of the segmentation of the beef market and existing patterns of in-quota and out-of-quota trade. The section also assesses the potential impact on animal welfare, taking account of current legislation in the countries concerned and the existing framework for EU-Mercosur dialogue and cooperation.
- EU dairy exports to Mercosur increase by 91% (conservative) and 121% (ambitious) as a result of a reduction of high import duties in Mercosur. The recognition of denomination of origin by Mercosur countries may expand exports of cheese further. For Mercosur exporters, the agreement expands dairy exports to the EU by 18% (conservative) and 165% (ambitious) but from a low base; and further expansion will depend on more Mercosur exporters improving sanitary conditions, animal welfare and other quality features in production.
- EU exports of beverages to Mercosur expand by 36% (38% in the ambitious scenario) and exports from Mercosur by 28% (35% in the ambitious scenario). In the case of the EU exports, this is expected to be concentrated in wine and spirits and it will be primarily attributed to the tariff reduction. In the case of Mercosur, the expansion is likely to be concentrated in wine. Effects on output and consumption in both Mercosur and the EU are very small in both scenarios. The potential impact of the Agreement on fruit juices, which are not covered by the same aggregate as alcoholic beverages and soft drinks in the model, is addressed in the sectoral analysis regarding historic tariffs and trade flows.
- The agreement will bring an increase of 32% (36% in the ambitious scenario) in the Mercosur exports to the EU of textiles and clothing. At the same time, EU exports to Mercosur will expand by 311% (424% in the ambitious scenario). This is the result of the reduction of very high tariffs in Mercosur on EU exports. Nevertheless, these changes in bilateral trade fail to translate into important changes in output and consumption in both the EU and Mercosur. Consequently, the social effects associated with employment in a sector with a high degree of informality and a large share of women employed tend to be minimum.

- The reduction of tariffs and non-tariff barriers applied to pharmaceutical and chemical products in both Mercosur and the EU will expand EU exports to Mercosur by 47% and imports by 13% in the conservative scenario. Output in the EU will expand by 0.2%. In Brazil, it remains unchanged in the conservative scenario and increases by 0.2% in the ambitious scenario and Argentina, it contracts by 0.2% in both scenarios. In Brazil, both skilled and unskilled employment fall by 0.5% in both scenarios. In Argentina, they fall by 0.7%-0.9% depending on the scenario. However, the increase in the trade and lower import prices generated by the lower tariffs is likely to benefit other manufacturing sectors and the agricultural sector.
- EU exports to Mercosur of machinery expand by 78% in the conservative scenario and by 100% in the ambitious scenario. EU imports from Mercosur expand by 17% in the conservative scenario and by 22% in the ambitious scenario. In Mercosur, the agreement generates a contraction of production between 1.4% and 3.2% in the conservative scenario (between 1.4% and 5.1% in the ambitious scenario). Both skilled and unskilled employment fall by corresponding amounts. However, this increase in trade is likely to benefit other sectors, both agricultural and industrial, due to improvement in the access to capital goods. EU exports to Mercosur of electronic equipment will expand by 109% in the conservative and 149% in the ambitious scenario. EU imports will expand by 16% (conservative) and 24% (ambitious). In Mercosur, output will increase between 0.4% and 2.1% (conservative) and between 0.8% and 2.6% (ambitious).
- There will be significant increases in trade in vehicles and vehicle parts between the two parties with EU exports increasing by 95% and imports by 41% in the conservative scenario. EU exports increase by 114% and imports by 47% in the ambitious scenario. EU will expand its output by 0.5%/0.6% in the conservative/ambitious scenario and Mercosur will contract its output by 1.7%/1.8% (Brazil) and 2.8%/3.2% (Argentina) in both scenarios. The agreement may lead to reform of the current Mercosur Common Automobile Policy which may have additional effects on the sector in the region in a more liberal direction.
- The agreement generates small changes in the trade of business and professional services with EU imports from Mercosur growing by 6.5% in the conservative scenario (by 9.2% in the ambitious one) and exports decreasing by 3.4% in the conservative scenario (and increasing by 1.4% in the ambitious scenario). This is the result of relatively lower barriers to investment and trade in the sector (in both parties). Nevertheless, in both scenarios, the agreement generates increases in output in Mercosur which are associated with the supply of services to other sectors that may see their output expanded by the agreement.
- The financial sector also experiences modest increases in Mercosur exports to the EU in both scenarios and output in Mercosur. In the EU financial services output contracts marginally in both scenarios. EU financial services exports to Mercosur decrease slightly in the conservative and increase slightly in the ambitious.

There are no significant effects on the outermost regions of the EU or least developed countries (LDCs). This is the case given the limited impacts on the sugar sector and because Mercosur is not a major exporter of bananas. Although in relative terms the increases in the textiles and apparel trade of Mercosur appear large, in absolute terms they are small.

Consumers may experience benefits as a result of lower prices. In the EU, the impact on consumption tends to be small, although positive in all products. In Mercosur, consumers will experience larger changes notably as regards vehicles consumption, which increases by 1.7%/2.2% in Argentina and 0.6%/0.8% in Brazil in the conservative/ambitious scenario with many other sectors seeing a marginal decline driven in large part by an increase in exports.

Finally, this study formulates recommendations for flanking measures to mitigate any potential risk of negative impact and to maximise potential benefits.

The main recommendations derived from the economic and sectorial analyses are to gradually introduce tariff changes in Mercosur, particularly in economic sectors that are more vulnerable to negative economic impacts (for instance vehicles and machinery). In the same vein, retraining and upskilling programmes are suggested to support the transition of workers between sectors. On the EU side, the use of quotas and partial liberalisation measures should be considered for sensitive agricultural products.

Measures to protect workers (e.g. labour inspection programmes, labour formalisation policies and supporting freedom of association), together with redistributive programmes, should be considered to mitigate social impacts and drive benefit from the FTA. Due diligence measures for businesses at the EU-level would also strengthen potential social benefits.

Recommendations for the environment highlight measures to decrease deforestation and contamination of water resources in Mercosur countries, as well as fulfilling the Paris Agreement commitments and fostering the development of green technology and sharing good practices between parties.

Finally, recommendations for the Human Rights area stress the strengthening of accountability measures and implementation of institutional frameworks that address changes in labour conditions, use of land that affects indigenous peoples, access to health and development of medicine, and gender equality issues.